Supreme Court, U.S.
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No.

In The
Supreme Court of the United States

RICHARD NICHOLAS, et al.,
Petitioners,

v.

SAUL STONE & COMPANY, LLC, et al.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In this case, the District Court for the District of New Jersey held, in relevant part, as follows: (i) that the Petitioners do not have a private remedy for violations of National Futures Association ("NFA") bylaws and rules, in particular NFA Bylaw 1101 - the NFA's "cornerstone" of self-regulation for the protection of the public interest; and, (ii) that the NFA may not be held liable pursuant to 7 U.S.C. §25(b)(2) unless it fails to enforce a bylaw or rule required under 7 U.S.C. §21 and determined, further, that NFA Bylaw 1101 is not such a required bylaw. The Third Circuit Court of Appeals, without specific reference or discussion, adopted the conclusions reached by the District Court with respect to each of these issues. The questions presented are:

1. Do investors in commodities futures contracts have a private cause of action against NFA Members for damages resulting from violations of NFA Bylaw 1101?

2. Is NFA Bylaw 1101 an intended requirement of the Commodity Exchange Act ("CEA")?

PARTIES TO THE PROCEEDING

Petitioners

Richard Nicholas; Lynn Nicholas; Robert M. Blackburn; Cheryl S. Blackburn; On Behalf of Themselves and On Behalf of the Class of All Others Similarly Situated.

Rule 29.6 Corporate Disclosure Statement

Petitioners are not corporations, but consist of individual persons. Therefore, no parent or publicly held company owns 10% or more of the stock of Petitioners, as such is not applicable.

Respondents

Saul Stone & Company LLC f/k/a Saul Stone And Company; First Options of Chicago, Inc. d/b/a LIT Division of First Options; Smith Barney, Inc.; LFG, LLC f/k/a Linnco Futures Group, Inc.; Dean Witter Reynolds, Inc.; ING (U.S.) Securities Futures & Options, Inc. d/b/a ING Futures & Options; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Prudential Securities, Inc.; Rosenthal Collins Group, L.P. f/k/a Rosenthal & Company; E.D. & F. Man International, Inc. f/k/a E.D. & F. Man International Securities, Inc.; and, National Futures Association.

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Petition For A Writ Of Certiorari

Richard Nicholas, Lynn Nicholas, Robert M. Blackburn and Cheryl S. Blackburn, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Third Circuit dated August 7, 2000 (Pet. App.[1], 4a - 30a) is unpublished. The Opinion of the District Court for the District of New Jersey dated June 30, 1998 (Pet. App., infra 33a - 91a) is unpublished.

JURISDICTION

United States Court of Appeals for the Third Circuit issued its Judgment on August 7, 2000 (Pet. App. 1a - 3a) and its Opinion (Pet. App. 4a – 30a). This Petition for Writ of Certiorari is filed within Ninety (90) days of the Opinion and Judgment of the Third Circuit. The Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

[1] Citations to "Pet. App." Are to the appendix filed with this Petition for Writ of uant to Supreme Court rule 14(i).

STATUTORY AND RULE PROVISIONS INVOLVED

The pertinent rule and statutory provisions are reproduced in the Appendix. The rules involved are NFA Bylaw 1101 and its related Interpretive Notice (Pet. App. 147a). The statutes involved are 7 U.S.C. §§21 (Pet. App. 154a - 178a), 25 (b)(2) (Pet. App. 179a).

STATEMENT OF THE CASE

This case presents questions of broad practical importance to the administration of the CEA, 7 U.S.C. §1, et seq., and the self-regulatory scheme created thereby. The Third Circuit and the District Court effectively set aside and ignored the underlying purpose of the CEA without acknowledging the legislative intent and proper statutory construction in favor of a superficial and mechanical result. Its reading effectively renders self-regulation to become no regulation, by prohibiting the public, for whom the CEA is to protect, the right to a private cause of action for damages caused by NFA Members for violations of its Bylaw 1101, set forth at Pet. App. 145a.

The essence of NFA Bylaw 1101 prohibits any NFA Member from conducting customer business with a non-member that is required to be registered. Mandatory membership in the NFA is the "cornerstone" of NFA's regulatory structure. Anyone who accepts orders, money, or securities for the purpose of effectuating a purchase or sale of a commodity futures contract must register with the NFA.

The Third Circuit further extends the theme of no regulation by disallowing Petitioners the right to sue the NFA for its failure to enforce said Bylaw and determining that NFA Bylaw 1101 was not required by the CEA pursuant to 7 U.S.C §21. The Commodity Futures Trading Commission ("CFTC") Order of 1981 (Pet. App. 92a – 120a) in granting registration and approving rules of the NFA as a registered futures association, substantially relied upon the compulsory language of NFA Bylaw 1101. The Third Circuit ignored the CFTC Order of 1981 and the discussion therein regarding Bylaw 1101.

A. Statutory Background

The statutory policy behind the enactment of the CEA is to protect the **national public interest** through the registration of those persons accepting an order or handling a transaction in commodity futures contracts. "Transactions in commodity involving the sale thereof for future delivery as commonly conducted on boards of trade and known as 'futures' are affected with a national public interest." 7 U.S.C. §5. Likewise, Congress determined in 1974, Pub. L. 93-463, "that the activities of ... commodity pool operators are affected with a national public interest ... ." 7 U.S.C. §6l. The Congressional intent continued in consistent form and substance as part of 7 U.S.C. §21(b)(1) disallowing the registration of a futures association unless the CFTC finds that such association is in the public interest.

Congress first enacted 7 U.S.C. §21, Registered Futures Association, in 1974 without Subsection (m), as it exists today. Subsection (m) was added to 7 U.S.C §21 in 1978 as part of Pub. L. 95-405, §22(4), with former Subsection (m) redesignated as Subsection (n).

The creation of Subsection (m) was in response to the NFA's initial failed application for registration as a futures association pursuant to 7 U.S.C. §21, as such was deemed not to be the least anti-competitive means of achieving the objectives of the CEA. The CEA requires the CFTC to balance various statutes in its quest to approve a registered futures association and its bylaws, rules or regulations. 7 U.S.C. §19 reads:

> "The Commission [CFTC] shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the

objectives of this chapter, as well as the policies and purposes of this chapter, ... in requiring or approving any bylaw, rule, or regulation of a ... registered futures association pursuant to §21 of this title."

7 U.S.C. §21(m) reads:

"Rules requiring membership in associations -

"Notwithstanding any other provision of law, the Commission [CFTC] may approve rules of futures associations that, directly or indirectly, require persons eligible for membership in such associations to become members of at least one such association, upon a determination by the Commission that such rules are necessary or appropriate to achieve the purposes and objectives of this chapter (CEA)."

The CFTC has primary responsibility to administer and enforce the CEA. The approval by the CFTC of NFA Bylaw 1101, a rule prohibiting NFA Members from doing business with non-members, was a reaffirmation of the statutory intent of the CEA, 7 U.S.C. §§6d, 6e, 6k and 6n, requiring defined participants in the futures industry to register with the CFTC. In the case of 7 U.S.C. §6d, futures commission merchants ("FCM" or collectively "FCMs") are required to register with the CFTC before soliciting or accepting orders to trade commodities, futures contracts and commodity options.

B. Registration Of The NFA

On January 15, 1977 the CFTC received a document entitled "National Futures Association Organizing Committee - Points of Agreement." Thereafter, on June 7, 1977, the CFTC received a statement from NFA's organizers in favor of compulsory [NFA] membership. The CFTC voted to approve the following statement:

> "The Commission [CFTC], as a matter of policy, approves the concept of `uniform required membership' (emphasis added) as proposed by the NFA organizing committee. This approval is stated in the abstract, ... , and would be the basis for the proposed NFA structure, ..."

Such uniform required membership served as the basis for NFA Bylaw 1101. The submission by the NFA's organizers was regarded as an application for registration and was addressed by the CFTC on October 7, 1977 in a document entitled, "In The Matter Of: The National Futures Association, Comments of the United States Department of Justice." The initial proposal by the NFA was deemed to be anti-competitive pursuant to 7 U.S.C. §19 (see Pet. App. 110a - 114a).

Subsequent to the enactment of Subsection 21(m), on March 16, 1981, the NFA again submitted an application to the CFTC for registration as a registered futures association under 7 U.S.C. §21 of the CEA. The CFTC entered an Order in 1981 Granting Registration And Approving Rules, In the Matter of the Application of the NFA (the "CFTC ORDER") (Pet. App. 92a). The CFTC noted in the CFTC ORDER at pages 4 and 5 (Pet. App. 93a) thereof, entitled "Overview of NFA Application, A Structure of NFA," the following:

> "The NFA has determined that in order for it to exercise its regulatory authority effectively, membership in the NFA ... should be compulsory (emphasis added) for FCMs and their agents, CPOs and CTAs. The rules do not explicitly compel such membership, but proposed bylaw 1101 would prohibit NFA members from carrying accounts, accepting orders, or handling accounts for or on behalf of any ... non-member (emphasis added) of the NFA who is not a member of another registered futures association, unless such person is exempted from the provisions of bylaw 1101 .... In addition, bylaw 301 would require APs of FCMs to register with the NFA as `associates.' Consequently, each step in the order-handling process leading to execution by a floor broker ... would have to be effected through an NFA member or a person subject to the NFA regulation." Pet. App. 93a - 94a.

The cumulative effect of the NFA's rules and the regulatory functions is to demonstrate that the CFTC's registration of the NFA will benefit the public interest. Pet. App. 100a. "Requiring membership in a registered futures association is an essential factor in providing the effective, industry-wide customer protection that the NFA proposes." Pet. App. 114a. The NFA's compulsory membership requirement was substantially the same before and after the enactment of 7 U.S.C. §21(m).

7 U.S.C. §21(b)(1) prohibits the CFTC from registering the NFA unless it is able to find that the NFA "is in the public interest (emphasis added) and that it will be able to comply with

the provisions of this section [§21] and the rules and regulations thereunder to carry out the purposes of this section [§21]." Pet. App. 155a.

The CFTC believe[d] that the commodities industry is not only prepared to assume, and capable of exercising, self-regulatory responsibility with respect to the activities of industry participants, but also better equipped to devote the resources necessary to significantly reduce the considerable number of customer abuses that have occurred in the absence of effective self-regulation. "The effectiveness of this approach, however, would be jeopardized if the NFA did not have provisions which, in effect, compel (emphasis added) NFA membership by industry participants." Pet. App. 104a. In approving the NFA's registration, the CFTC approved the NFA's compulsory membership requirement of Bylaw 1101 as necessary and/or appropriate to achieve the purposes of the CEA, pursuant to the CFTC's authority under 7 U.S.C. §21(m). In the NFA's case, the compulsory membership requirement is indirect, i.e. members cannot conduct business with non-members. Pursuant to NFA Bylaw 1101, once joining the NFA, members would be prohibited from engaging in any customer-related business with, or on behalf of, any non-member (or suspended member) FCM, CPO, CTA, or agent that is neither a member of another registered futures association nor otherwise exempted from this prohibition. Pet. App. 109a - 110a.

The CFTC determined that "Requiring membership in a registered futures association is an essential factor (emphasis added) in providing the effective, industry wide customer protection that the NFA propose[d]. If membership were purely voluntary, those engaging in abusive practices could evade self-regulatory compliance and sanctions simply by not joining, or by resigning from, the NFA or any comparable

organization," Pet. App. 114a [2] (like Kohli, Chandran and the Sigma Entities in the case at bar).

C. Factual Background

The Petitioners are a class of individual investors (400 persons in all) who were defrauded out of approximately $41 million dollars during the period of January 1, 1989 through April 12, 1995 in a Ponzi scheme designed and executed by Charles Kohli (at all times herein referred to as "Kohli"), Ram Chandran (at all times herein referred to as "Chandran") and through various commodity pools collectively known as and at all times referred to herein as the "Sigma Entities." Kohli, Cahndran nor the Sigma Entities were NFA members. Respondent FCMs were at all relevant times NFA members. The majority of these funds were placed with Respondent FCMs to trade commodities, futures contracts and commodity options. Pet. App. 41a.

All FCM Respondents admit to trading with a non-member in violation of NFA Bylaw 1101. The FCM Respondents failed to conduct due diligence, make inquiries and obtain required Disclosure Documents pursuant to 17 CFR §§4.21 and 4.24 with respect to the NFA membership status, financial condition and source of the deposited funds of Kohli, Chandran and the Sigma Entities, Pet. App. 42a and 46a, as required in part by NFA Bylaw 1101.

As of the date of this Petition for Writ of Certiorari, the NFA has failed to discipline any of the Respondent NFA

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[2] Such is the result in the case at bar under circumstances where the NFA fails and refuses to enforce NFA Bylaw 1101.

members for violations of Bylaw 1101. Despite the fact that Respondents FCMs carried accounts, accepted orders and handled transactions on behalf of parties not members of the NFA – no disciplinary action has been taken by the Respondent NFA and no thorough, diligent and vigorous investigative action has been initiated by the NFA concerning the management and conduct of the FCM Respondents. Pet. App. 47a. In particular, the Respondent Saul Stone & Company LLC was previously involved in two similar "Ponzi" schemes. In September 1982 and thereafter, in June 1985 Saul Stone & Company LLC received actual notice of Ponzi schemes in which it was the acting FCM. Pet. App. 47a. The NFA also failed to discipline Saul Stone & Company LLC in both previous instances, notwithstanding the strict liability standard of NFA Bylaw 1101.[3]

There are no facts in dispute regarding the violations of Bylaw 1101 or the inaction of the NFA to discipline Respondent Members for such violations.

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[3] Although not parties to this Petition, the individual defendants, Thomas H. Stone ("Stone") and Clarence Delbridge, III ("Delbridge") were employed in executive positions with Saul Stone & Company LLC. Stone was a Member of the NFA and an elected member of the Advisory Committee of the NFA for FCMs. Delbridge was a NFA Member and an elected member of the Regional Business Conduct Committee of the NFA for the Central Region. Initially, the Regional Business Conduct Committee's role was to engage in fact-finding and recommending disciplinary actions. Its role was later changed to determining whether regulatory actions should be brought against NFA Members. In either case a conflict of interest exists.

D. Proceedings Below

On February 13, 1997 Petitioners filed a Class Action Complaint and thereafter, a First Amended Class Action Complaint on November 23, 1997 in the District Court for the District of New Jersey seeking recovery of losses from Respondent FCMs, the NFA, and individuals Clarence Delbridge, III and Thomas H. Stone for violations of NFA Bylaw 1101, 7 U.S.C. §§21, 25(a) and (b) of the CEA, breach of contract and other statutory and common law claims. The District Court had jurisdiction because the action arose in part under the CEA and other Federal questions.

A unanimous panel of the Third Circuit (Roth and Rendell, Circuit Judges and Pollak, District Judge sitting by designation) Affirmed the judgment of the District Court of June 30, 1998. Pet. App. 1a – 3a.

REASONS FOR GRANTING THE PETITION

The Third Circuit, by adopting the findings and opinions of the District Court (Pet. App. 29a – 30a) has cut the CEA loose from its legislative purposes in important respects that warrant review by the Supreme Court.

The underpinnings of the CEA require registration of participants in the futures industry for the national public interest. The Third Circuit - in conflict with the Second Circuit – held that Bylaw 1101 should only be enforced by the NFA. The Northern District of Illinois, Eastern Division, although relied upon by the District Court and the Third Circuit in the case at bar, recognized that NFA Bylaw 1101 was a rule of great importance, but received less than persuasive justification for reaching a different outcome. On the other hand, the Second Circuit required a reasonable inquiry. Consistent with

the Second Circuit, the CFTC, through an Administrative Action, acknowledged that compulsory membership is a must and may render a respondent liable for damages, while also welcoming private actions.[4]

The legislative intent of the CEA as well as the NFA interpretation of Bylaw 1101 clearly indicate that Bylaw 1101 is the cornerstone of self-regulation in the commodities markets and is intended to protect the public. It is a specific rule with acknowledged importance. The NFA publicly represents an intent to impose "strict liability" for Bylaw 1101 violations. Pet. App. 148a. The NFA admits the right to pursue a private cause of action for a violation of a NFA bylaw or rule by specifically disallowing such a right in the Interpretive Notice for NFA Compliance Rule 2-30. There would be no such notification where no such right otherwise exists.

Simply put, the public is not protected against commodity frauds and Ponzi schemes as intended by the legislature under the CEA. There has been no CFTC intervention on behalf of the public. To the contrary, the CFTC asserts it lacks resources to prosecute on behalf of the public interest and maintains that the public's only recourse is its private right of action. " ... private rights of action are an important supplement to government enforcement actions in helping to ensure lawful conduct in the commodities industry." Pet. App. 135a.

The facts of this case demonstrate the lack of NFA enforcement of Bylaw 1101. The NFA incorrectly argues that

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[4] See Argument I.A. at page 13, inra., for specific case references.

Bylaw 1101 is not a rule required by 7 U.S.C. and therefore it has no liability.

If the CFTC lacks resources to enforce, and the NFA refuses or simply fails to enforce, then the public must have a private right of action to enforce. Without a private right of action for Bylaw 1101 violations, there simply is no meaningful regulation. The CEA and the NFA Bylaw 1101 are impotent.

The Court's review is warranted to resolve the conflicts among the judiciary, regulatory bodies, legislative intent and association rule enforcement in conjunction with this Court's re-evaluation of Cort v. Ash, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed. 2d 26 (1975), its progeny, and to forestall further deterioration of the CEA for customer protection.

ARGUMENT I:
THE SUPREME COURT SHOULD RESOLVE THE CONFLICT OVER NFA BYLAW 1101 IN FAVOR OF A PRIVATE CAUSE OF ACTION

The inclusive legislative intent of the Futures Trading Act of 1982 (Pet. App. 181a) is in conflict with the conclusion of the District Court as adopted by the Third Circuit.

The refusal to allow Petitioners to pursue a private cause of action due to a violation of NFA Bylaw 1101 frustrates the Congressional goal to protect the investing public. The narrow view taken by the District Court and adopted by the Third Circuit ignores the fact that private rights of action supplement, but do not substitute for the regulatory and enforcement program of the CFTC and self-regulatory agencies like the NFA. "The Committee [Congress] fully expects that these agencies [the NFA] will vigorously use the tools at its

command to protect the investing public so that it does not become necessary to rely on private litigants as a policeman of the CEA." Pet. App. 184a. Futures Trading Act of 1982, Pub.L. 97-444; House Report No. 97-565, Part I, page 57. The right of an aggrieved person to sue a violator of the CEA[5] is critical to protecting the public and fundamental to maintaining the credibility of the futures market. Pet. App. 185a.

In plain language, Congress created a private cause of action pursuant to 7 U.S.C. §25, "to avoid suits for speculative damages to assets that are affected by fluctuations in prices on the commodity market but which are not the subject of transactions on such market." Pet. App. 184a. The legislative intent was clearly not an attempt to otherwise limit Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353 (1982), but in response to it. This is further confirmed by the CFTC's welcome of private litigants for the enforcement of the CEA. Pet. App. 135a. NFA Bylaw 1101 is the corollary to and companion of the statutory make-up of the registration provisions of the CEA, 7 U.S.C. §§6d, 6e, 6k, and 6n. As such Congress intended Bylaw 1101 to be mandatory and enforced by private litigants as an additional mechanism to avoid fraud by non-members of the NFA.

Congress's simple objectives are thwarted by the decision challenged by this Petition. We ask the Court to review the conflicts and the importance of the issues by granting the Petition.

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[5] NFA Bylaw 1101 is required and created pursuant to the CEA.

A. The Courts Are Divided On The Impact Of NFA Bylaw 1101 And The Right Of A Private Investor To Pursue A Cause Of Action For A Violation Thereof

The Opinions of the Third Circuit and the District Court for the District of New Jersey ignore Peltz v. SHB Commodities, Inc., 115 F.3d 1082 (2d Cir. 1997). The Second Circuit's decision in Peltz is consistent with the fundamental purpose of the NFA (Pet. App. 143a), requirements of NFA Bylaw 1101 (Pet. App. 145a) and its Interpretive Notice (Pet. App. 147a) and allows for a cause of action against an NFA Member, where there is a failure by a futures commission merchant to perform minimal due diligence. The conflict between the Third Circuit and the Second Circuit in Peltz is easily recognized.

Generally, before accepting trades from a third party, the FCM must make a reasonable inquiry into the nature and extent of the individual's authority. Peltz v. SHB Commodities, Inc., 115 F.3d 1082 (2d Cir. 1997). Likewise, if the third party is required to be a Member of the NFA the FCM must make a reasonable inquiry into same as well, which was not done by the FCMs of Kohli, Chandran and the Sigma Entities herein.

It is crystal clear from the legislative history that NFA Bylaw 1101 is more than a membership rule. It is the single most important requirement of the CEA and is recognized as the cornerstone of self-regulation. However, the Second Circuit in Peltz, the Third Circuit in the case at bar and the Northern District of Illinois, Eastern Division, in the Matter of Lake States Commodities, Inc., 936 F. Supp. 1461 (7th Cir.

1996) are at odds regarding liability under NFA Bylaw 1101 or have skirted the issue.

The Third Circuit adopted the Opinion of the District Court, which relied on other cases, mostly within the Northern District Court of Illinois and the Seventh Circuit. Pet. App. 7a.[6]

Further, the District Court for the Northern District of Illinois, Eastern Division, in the Matter of Lake States Commodities, Inc., 936 F. Supp. 1461 (7th Cir. 1996), declined to imply a private cause of action into Bylaw 1101 and its Interpretive Notice, due to plaintiffs' failure to offer persuasive justification for reaching a different outcome. That court relied upon the Seventh Circuit cases of Indemnified Capital Invs., S.A. v. R.J. O'Brien & Assoc., Inc., 12 F.3d 1406, 1412 (7th Cir. 1993) regarding NFA Compliance Rule 2-4 and Spicer v. Chicago Board of Options Exchange, Inc., 977 F.2d 255, 265 (7th Cir. 1992) regarding §6(b)(5) of the Securities Exchange Act of 1934 for violations of Chicago Board of Option rules. In both instances the courts refused private cause of actions against FCMs and market-makers for alleged failure to comply with association and exchange rules which govern internal operations regarding "just and equitable principles of trade."

The Court in the Matter of Lake States Commodities, Inc., supra. 1469 (7th 1996), was looking for the plaintiffs to

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[6] Neither the District Court nor the Third Circuit addressed the decision of the Southern District Court of Texas, wherein the Court refused to make a blanket statement that all violations of Exchange [NFA] rules would support a claim for private relief. Porter v. Shearson Lehman Brothers, Inc., 802 F. Supp. 41, 61 (S.D. Texas 1992).

offer a persuasive justification for a different outcome, recognizing that the plaintiffs therein were not relying on the same rules at issue in Indemnified Capital Invs., S.A. and Spicer.

NFA Bylaw 1101 is a regulatory rule to stop the commencement of fraud (much like that described in 7 U.S.C. §6b) by non-members of the NFA. Much like Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982), NFA Bylaw 1101 is a guide to stop fraud by non-members of the NFA. Therefore, violations of NFA Bylaw 1101 as an antifraud provision of the CEA should entitle Petitioners to file a private cause of action against the FCM Respondents.

Further, the CFTC welcomes private lawsuits as specifically noted in In Acampora v. Prudential Bache Securities, Inc., [1986]-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,792 (C.F.T.C. 1987), an Administrative Law Judge found that a failure to register on the part of a respondent was caused by an oversight. The Judge stated that the failure to register is a per se violation of the CEA and may render a respondent liable for damages.

The conflict among the courts and regulatory bodies - NFA and CFTC is ripe for resolution by the Supreme Court.

B. Investors Are Entitled To A Private Cause Of Action For Damages Resulting From Violations Of NFA Bylaw 1101

Private enforcement of NFA Bylaw 1101, is a matter of first impression before the Supreme Court, a true rule for the public's protection.

The case of Porter v. Shearson Lehman Brothers, Inc., 802 F. Supp. 41, 61-63 (S.D. Tex. 1992). The aforesaid case cites the seminal case of Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966), cert. denied, 385 U.S. 817, 87 S.Ct. 40, 17 L. Ed. 2d 56 (1966), finding that, "Congress did not intend that violations of all Exchange [NFA] Rules would support a claim for private relief. It found, rather, that the quote "just and equitable" requirement (much like the case of In re Indemnified Capital Investments, S.A. v. R.J. O'Brien & Associates, Inc., supra.) was extremely broad and that Congress intended to rely upon the disciplinary function of the Exchange to vindicate such broker-dealer misconduct. The Court suggested, however, the **more specific** (emphasis added) the rule ... the more likely that the court shall infer liability. The Court in Colonial Realty Corp. v. Bache & Co., supra, noted that, " NYSE Rule 452, which outlines the method of voting stock held in a street name, might support a private cause of action because of the integral part [it played] in SEC Regulation." Id. at 182. "This emphasis on the place of the NASD Rule and the complete regulation of the securities market (emphasis added) gave rise to what has been termed the Colonial Realty substitution test." The more specific the rule and the more integral a part it plays in the total scheme of securities regulation, the more likely that the Court should infer liability. This analysis was likewise followed by the Court in Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir. 1969), cert. denied, 396 U.S. 838, 90 S.Ct. 98, 24 L. Ed. 2d 88 (1969), where the Court of Appeals for the Seventh Circuit held that liability could be implied from a breach of NYSE Rule 405. The Court emphasized investor protection and the remedial purpose of NYSE Rules instead of stressing, as did Colonial Realty Corp. the place the regulation played in the total context of investor protection.

1. NFA Admits Regulatory Intent To Allow Private Right To Enforce Bylaw 1101

Notwithstanding the fact that the Buttrey Court found NYSE Rule 405 to allow for a private cause of action the NFA has specifically indicated in its "Know your customer" rule, Rule 2-30 [NYSE Rule 405 is a know your customer rule], that such shall not allow for a private cause of action specifically referencing NYSE Rule 405, for several reasons. First, a business conduct standard promulgated by a self-regulatory organization does not create a private clause of action. Second, NFA Rule 2-30 is not an anti-fraud rule." The NFA equates an industry housekeeping process to a business conduct standard. The NFA specifically places us on notice that NFA Rule 2-30 should not specifically be construed to expose members to increased potential liability for damages in litigation or administrative proceedings. Since this particular qualification does not appear in any other Interpretive Notice nor NFA bylaw and rule, one may, by process of elimination, state that there is a private cause of action against the NFA for violation by it or any of its Members of any other bylaw or rule. On the other hand, the NFA should not be allowed to protect its Members from a private cause of action in a self-regulated industry when the bylaws or rules have an inherently important place in the complete regulation of the commodities market and for the protection of the public investor.

In re Indemnified Capital Invs., S.A. v. R.J. O'Brien & Associates, Inc., 12 F.3d 1406, 1412 (7th Cir. 1993) the Court of Appeals affirmed the dismissal of a breach of fiduciary duty claim based on NFA Compliance Rule 2-4. NFA Compliance Rule 2-4, "Just And Equitable Principles Of Trade," is concerned with the conduct of the commodity futures business and that the NFA Members and Associates shall observe high standards of commercial honor and just and

equitable principles of trade in the conduct of the commodity futures business. This Rule must be deemed a business conduct standard. This is very much like NFA Rule 2-30. NFA Compliance Rule 2-30 is a "know your customer" rule; however, it does not require the Member or Associate to make the final determination that a customer should be barred from futures trading on suitability grounds. Some "know your customer" rules in the securities industry (New York Stock Exchange Rule 405, for example) have been construed in that manner; these interpretations do not apply to NFA Rule 2-30.

2. NFA Bylaw 1101 Is A Specific Rule For The Public's Protection

On the other hand, NFA Bylaw 1101 is more than a business conduct standard. NFA Bylaw 1101 is one of the Rules that are very specific and not general. The Second Circuit Court of Appeals requires a FCM to make a reasonable inquiry to determine if a third party is required to be licensed. NFA Bylaw 1101 requires Members to make two determinations: whether it is doing business with an entity requiring registration, and if so, whether that person is an NFA Member. The second of these determinations is simple. Any Member can call NFA's information center at a toll free number (1-800-621-3570) to receive current and accurate information concerning the Membership status of any person.

NFA Bylaw 1101 is more than a business conduct standard and is to be enforced with strict liability. Therefore, a per se violation has a private cause of action. The Rule does not require proof that the Member firm was at fault or failed to exercise due diligence - "simply that it transacted business with a non-member that is required to be registered." Pet. App.

147a.[7] If NFA Bylaw 1101 is not treated at a higher level than a typical business conduct standard there will be no mechanism to stop those who are not registered from trading with an FCM.[8]

The case of Cort v. Ash, 422 U.S. 66, 78, 95 S.Ct. 2080, 2088, 45 L. Ed. 2d 26 (1975) sets forth four (4) major factors to be considered when determining the existence of a private right of action under a federal statute which does not provide for one. The same four (4) factors should be viewed in determining whether or not NFA Bylaw 1101 should allow for a private cause of action. The factors are as follows:

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[7] Reference is hereby made to the Compliance Guide at Pet. App. 151a - 153a), which states that, "it was not until 1978, when Congress specifically authorized mandatory membership, that the last major obstacle to the establishment of an effective self-regulatory organization was removed. ... Simply stated, this means that persons who are not or do not remain qualified for NFA membership are prevented or barred from dealing with the public in a business that involves buying or selling futures or options contracts for commodity customers. This is because they will be unable to obtain execution of their orders."

[8] As members of the NFA, the FCM Respondents are bound by the rules of the NFA - its rules are in the nature of agreements with all its members. Equidex, Inc. v. National Futures Association, Superior Court of New Jersey, Law Division, Hudson County, Docket No. HUD-L-9424-92 (1996). Judge Margulies found that membership in the NFA constituted a "contract" that binds members to perform under the rules. The only beneficiary of this contract is the public. Yet, the courts remain ambiguous and undecided as to the public's rights under this contract. The public is a third-party beneficiary of such an agreement.

(1) Is the Plaintiff one of the class where who special benefit the statute was enacted? - Yes, to protect the investor and the national public interest.

(2) Is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? - Yes, to disallow trading with one who is not registered pursuant to 7 U.S.C. §§6d, 6e, 6k, and 6n.

(3) Is it consistent with the underlying purposes of the legislative scheme to imply such a remedy to the Plaintiff? - Yes, to disallow trading with one who is not registered pursuant to 7 U.S.C. §§6d, 6e, 6k, and 6n and for the national public interest.

(4) Is this an area traditionally relegated to state law? – No

The time is right for the Supreme Court to revisit the Cort v. Ash factors. The association rule before us is one of great import to controlling fraud for the public benefit within the commodity industry and among NFA Members and non-members. By revisiting the factors for determining the right to a private cause of action for a violation of an association rule the Supreme Court will also have the opportunity to review the statutory intent of the CEA relative to NFA Bylaw 1101 as well as the discussions concerning the approval thereof by the CFTC before applying the factors to NFA Bylaw 1101. If not, the public will not be protected and the statutory intent will continue without clarity.

C. Commodity Ponzi Schemes Flourish Under Present State of Regulatory Controls - Outcome Important To National Public

Among a remarkable number of commodity frauds and Ponzi schemes there runs an alarming common thread. In case after case, NFA members violated Bylaw 1101 and conducted business with non-member defrauders. In each instance, the public was defrauded. In each instance, NFA members were able to pocket huge sums from commissions generated from the defrauded with impunity. In each instance, the violation of NFA Bylaw 1101 is discovered substantially after the occurrence of the fraud. However, the NFA's failure to enforce Bylaw 1101 leaves the FCM Members with little fear of disciplinary action and little desire to self-regulate. It is the very circumstances under which the CFTC suggests that there should be private causes of action for enforcement of the CEA. Petitioners reflect an exact profile of numerous other investors who have been defrauded under similar circumstances.[9]

The Respondent, Saul Stone & Company LLC, in September, 1982, had received an actual notice of a "Ponzi" scheme of Fraud and Deceitful Practices similar to that in the case at bar. A complaint was filed in that matter with the

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[9] For example, Princeton Economics International Ltd./Martin Armstrong (non-members) and Republic New York Securities (NFA Member) - $500 million dollar fraud, discovered 1999; Philip Ferguson (non-member), traded member FCMs – unknown losses, fraud discovered 2000; Robert H. Rutman (non-member), fraud discovered 1997; Lake States Commodities, Inc./Thomas Collins (non-members) and Heinhold Commodities (NFA Member) - $60 million dollar fraud, commenced in 1984 and discovered in 1994.

United States District Court for the Northern District of Illinois under No. 82-C-6611. In June, 1985, Saul Stone & Company LLC once again received a notice of a similar "Ponzi Scheme" in which a complaint was filed in the United States District Court for the Eastern District of Washington under No. C-855-522-RJM. Little, if any action has been taken by the NFA against Saul Stone & Company LLC for its past and present violations of NFA Bylaw 1101.

ARGUMENT II:
NFA BYLAW 1101 IS A REQUIRED RULE PURSUANT TO THE STATUTORY INTERPRETATION OF 7 U.S.C. §21

In order for the NFA to be held liable pursuant to 7 U.S.C. §25(b)(2) (Pet. App. 179a) it must have failed to enforce a bylaw or rule required by 7 U.S.C. §21. But for NFA Bylaw 1101, the CFTC would not have granted the NFA registration as a futures association.

In enacting Section 21(m), Congress took note that:

> "This objective [of self-regulation] would be frustrated if futures industry professionals were free to discontinue their membership in the relevant association or associations when their own acts and practices came under scrutiny or investigation ... ." Pet. App. 112a.[10]

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[10] S. Rep. No. 850, 95th Cong., 2d Sess. 31 (1978).

Congress thus affirmatively rejected arguments against a mandatory approach to futures association membership. Pet. App. 112a.

As used in 7 U.S.C. §21(m) (Pet. App. 173a), MAY means SHALL and is mandatory. Much like Harvey v. Essex County Board of Freeholders, 30 N.J. 381, 393, 153 A.2d 10 (1959), "may" was determined by the New Jersey Supreme Court to mean, "shall." In determining whether a statute is mandatory or directive regard shall be had to the proposed intent of the legislature. Harvey v. Essex County Board of Freeholders, supra. 391.

The CFTC must find, and did find, that the NFA is in the public interest and that it will be able to comply with the rules and regulations of 7 U.S.C. §21 in order to carry out the purposes thereof. The intended purposes could not be carried out without the required NFA membership. The New Jersey Supreme Court in Harvey v. Essex County Board of Freeholders, supra. 32, cited to and quoted from City of Bayonne v. North Jersey, etc., Commission, 30 N.J. Super. 409, 417-419, 105 A.2d 19 (App. Div. 1954), wherein it was held, "that the word 'may' must be given a mandatory significance where it is employed in a statute to delegate a power, the exercise of which is important for the protection of public interests (emphasis added) and where it can clearly be taken from the nature and the object of the statute, a mandatory significance was intended."

On the other hand, in the extraordinary case, where a literal reading of the statutory language produces an absurd result, further inquiry is required. Moreover, a court may depart from the plain language of a statute by an extraordinary showing of a contrary congressional intent. Idahoan Fresh v. Advantage Produce, Inc., 157 F.3d 197, 202 (3d Cir. 1998).

An analysis of the statutory language and the interpretation of it by the CFTC is more specifically set forth hereinabove in the Statement Of The Case - A. Statutory Background and B. Registration of the NFA, at pages 1 through 6, supra.. It is clear that Congress desired a mandatory approach to futures association membership. Pet. App. 112a. Likewise, the CFTC determined that such membership of a registered futures association was essential to avoid abusive practices. Pet. App. 114a. The approval of NFA bylaw 1101 as part of the CFTC ORDER can only be viewed as a required rule. One must give considerable weight to the CFTC's position and interpretation of the statute it is entrusted to administer. Judicial deference to reasonable interpretations by an agency of a statute that the agency administers is a dominant, well-settled principle of federal law. The court must look at the structure and language of the statute as a whole. National Railroad Passenger Corporation v. Boston And Maine Corporation, 503 U.S. 407, 417 (1992).

Registration of the NFA would not have been approved without NFA bylaw 1101. 7 U.S.C. §21(b) states, "An applicant shall not be registered as a futures association unless the Commission [CFTC] finds, under standards established by the Commission, that -

> "(1) such association is in the public interest (emphasis added) and that it will be able to comply with the provisions of this section (§21) and the rules and regulations thereunder and to carry out the purposes of this section ..."

This Court should read the language of the statute as a whole, in particular, 7 U.S.C. §§ 21(b), (m). In so doing, the only clear interpretation is to conclude that a registered futures association rule of mandatory membership is required pursuant

to 7 U.S.C. §21(m) to carry out the intended purposes of the CEA.

ARGUMENT III:
ENFORCEMENT OF NFA BYLAW 110 SHOULD BE CONSISTENT WITH THE ADMINISTRATIVE PROCEDURES ACT

To be consistent with the Administrative Procedures Act ("APA"), there must be judicial review of the standard of criteria applicable for the enforcement of NFA Bylaw 1101 in determining if Bylaw 1101 is required under the CEA.

Further, the District Court failed to conduct any probative evaluation of the deliberate and multiple failures of the NFA to enforce Bylaw 1101 when the authority to enforce was vested directly with the very violators of this Bylaw. This severe conflict of interest rises to the level of bad faith when the motive not to act in the public's interest is self-serving and when the association has actual notice, which it deliberately ignores.[11] Although bad faith action is required to enforce

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[11] Only partial guidance is available from existing law in Sam Wong & Son, Inc. v. N.Y. Mercantile Exchange, 735 F.2d 633 (1984). Dissimilar facts cloud the issue. In Sam Wong, the court found:

> "When self-interest or other ulterior motive unrelated to proper regulatory concerns is alleged to constitute sole or dominant reason for exchange action, complaint is sufficient even though action was not beyond bounds of reason; on the other hand, if governors sincerely and rationally believe their action was in the public interest, there should

liability against the NFA, pursuant to 7 U.S.C. §25(b)(4)[12], such is not the case with regard to violations thereof by its Members. Thus, the critical question of potential and probable self-dealing by self-regulatory agency members who hold positions of authority remains unresolved. This issue is of vital public importance because it represents the very core of self-regulation integrity.

The standard criteria for determining liability against a NFA Member for violation of NFA Bylaw 1101, particularly when the NFA fails to enforce and prosecute such a violation, should be no different than that required by the APA. The Court is qualified to decide whether the NFA has abused its discretion in this case. Neither the NFA's nor the CFTC's refusal to review are unsuitable for judicial scrutiny. Unlike Heckler v. Chaney, 470 U.S. 821 (1985), yet like Cardoza v.CFTC, 768 F.2d 1542 (7th Cir. 1985), it is fair to say that in the case at bar, a complete lack of judicial scrutiny of the NFA's decisions not to review and enforce Bylaw 1101 would frustrate congressional intent. Further, like Cardoza, there are meaningfully standards found in NFA Bylaw 1101 Interpretive Notice by which to review the NFA's actions. It is well settled "that regulations validly prescribed by a government administrator are binding upon him as well as the citizen, and

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> not be liability simply because exchange action has incidental effect of advancing their private interests or damaging someone they do not like. Commodity Exchange Act §22(b)(4) as amended, 7 U.S.C. §25(b)(4)."

[12] As in Sam Wong, supra., the issue of bad faith is not raised before the Supreme Court, but is subject to remand for factual review.

that this principle holds even when the administrative action under review is discretionary in nature. Cardoza, supra. However, in this case NFA Bylaw 1101 Interpretive Notice references strict liability for a violation thereof, the factor being whether the member knew or should have known. The Supreme Court has approved judicial review for an agency abuse of discretion. Cardoza, supra. The standard set forth in the APA at 5 U.S.C. § 706(2)(A), that an agency action may be set aside if it is "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law," is the appropriate one.

The NFA's actions should be reviewed within the standard criteria of NFA Bylaw 1101 Interpretive Notice. An investor who has been damaged from a violation of Bylaw 1101 should be entitled to pursue a private cause of action, particularly when the NFA fails to do so and it is deemed an abuse of discretion upon judicial review of the standard criteria.

In this case, the NFA refuses to enforce NFA Bylaw 1101 for the protection of the public, effectively avoiding its responsibility. Block v. S.E.C., 50 F.3d 1078 (D.C. Cr. 1995).

Agencies may find it worthwhile to give short shrift to a particular claim if the aggrieved party can file its own suit (as the futures markets may), for turning it over to private litigation frees up time without necessarily diminishing the enforcement of the statute (in this case, NFA Bylaw 1101). Board of Trade of City of Chicago v. S.E.C., 883 F.2d 525 (7th Cir. 1989).

The NFA consistently fails to enforce the required Bylaw 1101. The NFA does not maintain a consistent rule, pursuant to 7 U.S.C §21(b)(8), to appropriately discipline its

members and persons associated with its members, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules. By regularly and lightly sanctioning Saul Stone & Company LLC for violating NFA Bylaw 1101, a strict liability rule, NFA violates §21(b)(8), also a required rule.

Saul Stone & Company LLC has not been expelled after three (3) such violations. Saul Stone's ongoing failure to abide by NFA Bylaw 1101 and the NFA's failure to previously expel Saul Stone & Company LLC from its membership caused the Petitioners' losses. A finding of a "gross abuse of discretion" can be supported by proof of the suggestion that the NFA has consistently applied a different standard to the violations of "large and powerful FCMs," and thus exercised its powers discriminatorily. Hiller v. Securities And Exchange Commission, 429 F. 2d 856, 859 (2d Cir. 1970).

CONCLUSION

For the reasons set forth hereinabove, Petitioners respectfully request that the Petition for Writ of Certiorari be granted.

Respectfully submitted,

/s/_____
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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

[Filed August 7, 2000]

No. 98-5390

RICHARD NICHOLAS; LYNN NICHOLAS; ROBERT M. BLACKBURN; AND CHERYL S. BLACKBURN, ON BEHALF OF THEMSELVES AND ON BEHALF OF THE CLASS OF ALL OTHERS SIMILARLY SITUATED, *Appellants,*	)
v.	)
SAUL STONE & COMPANY LLC, F/K/A SAUL STONE AND COMPANY; FIRST OPTIONS OF CHICAGO, INC., dba LIT DIVISION OF FIRST OPTIONS; SMITH BARNEY INC; LFG, LLC, F/K/A LINNCO FUTURES GROUP, INC.; GNI INCORPORATED; DEAN WITTER REYNOLDS, INC.; ING (U.S.) SECURITIES FUTURES & OPTIONS, INC. dba ING FUTURES & OPTIONS; MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PRUDENTIAL	)

SECURITIES, INC.; ROSENTHAL)
COLLINS GROUP, L.P. F/K/A)
ROSENTHAL & COMPANY; E.D. & F.)
MAN INTERNATIONAL INC., F/K/A)
E.D. & F. MAN INTERNATIONAL)
SECURITIES, INC.; CLARANCE)
DELBRIDGE, III; THOMAS H. STONE;)
NATIONAL FUTURES ASSOCIATION;)
JOHN DOE; JOAN DOE; JACK DOE;)
JOSEPH DOE; JANE DOE; JAKE DOE;)
JEFF DOE; JEAN DOE; JAMES DOE;)
JILL DOE AND JOEL DOE; GNI)
LIMITED)
)

On Appeal from the United States District Court
for the District of New Jersey
District Judge: Honorable Anne E. Thompson
D.C. No. 97-860

Argued July 15, 1999.

Before: ROTH and RENDELL, *Circuit Judges* and POLLACK,* *District Judge*

* Honorable Louis H. Pollack, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of New Jersey and was argued by counsel on July 15, 1999.

On consideration whereof, it is now here ORDERED AND ADJUDGED by this Court that the judgment of the said District Court entered June 30, 1998, be, and the same is hereby AFFIRMED. Costs taxes against appellants. All of the above in accordance with the opinion of this Court.

ATTEST:

/s/_____
Acting Clerk

Dated: August 7, 2000

Certified as a true copy and issued in lieu
of a formal mandate on August 31, 2000

Teste: /s/_____

Clerk, United States Court
of Appeals for the Third Circuit

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

[Filed August 7, 2000]

No. 98-5390

RICHARD NICHOLAS; LYNN NICHOLAS; ROBERT M. BLACKBURN; AND CHERYL S. BLACKBURN, ON BEHALF OF THEMSELVES AND ON BEHALF OF THE CLASS OF ALL OTHERS SIMILARLY SITUATED, *Appellants,*	)
v.	)
SAUL STONE & COMPANY LLC, F/K/A SAUL STONE AND COMPANY; FIRST OPTIONS OF CHICAGO, INC., dba LIT DIVISION OF FIRST OPTIONS; SMITH BARNEY INC; LFG, LLC, F/K/A LINNCO FUTURES GROUP, INC.; GNI INCORPORATED; DEAN WITTER REYNOLDS, INC.; ING (U.S.) SECURITIES FUTURES & OPTIONS, INC. dba ING FUTURES & OPTIONS; MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PRUDENTIAL SECURITIES, INC.; ROSENTHAL COLLINS GROUP, L.P. F/K/A ROSENTHAL & COMPANY; E.D. & F.	)

MAN INTERNATIONAL INC., F/K/A)
E.D. & F. MAN INTERNATIONAL)
SECURITIES, INC.; CLARANCE)
DELBRIDGE, III; THOMAS H. STONE;)
NATIONAL FUTURES ASSOCIATION;)
JOHN DOE; JOAN DOE; JACK DOE;)
JOSEPH DOE; JANE DOE; JAKE DOE;)
JEFF DOE; JEAN DOE; JAMES DOE;)
JILL DOE AND JOEL DOE; GNI)
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Argued July 15, 1999.

Before: ROTH and RENDELL, *Circuit Judges* and POLLACK,* *District Judge*

OPINION OF THE COURT

POLLAK, District Judge.

Appellants seek review of a judgment of the District Court of New Jersey granting defendants' motion to dismiss plaintiffs' amended complaint. The District Court dismissed

* Honorable Louis H. Pollak, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

the complaint for lack of personal jurisdiction over the two individual defendants, and for failure to state any claims upon which relief could be granted against the other defendants. We conclude that it was proper for the District Court to grant the motion to dismiss, and hence we will affirm.

I. Facts

We begin by summarizing the principal facts alleged in the amended complaint-- facts to be taken as true for the purpose of testing the legal sufficiency of plaintiffs' claims. According to the amended complaint, the plaintiffs (suing both on their own behalf and also, putatively, as representatives of others similarly situated[1]) are persons who, between 1989 and 1995, were lured into improvident investments in the commodities market by Chuck ("Chuckles") Kohli, Nungambukkam Swamy Ramchandran,[2] and certain corporate pawns of Kohli and Ramchandran known collectively as "Sigma."[3] Plaintiffs alleged that Kohli, Ramchandran, and Sigma held themselves out as successful

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[1] The District Court dismissed the amended complaint prior to consideration of the appropriateness of class certification. In this court, therefore, the parties are limited to the named plaintiffs and defendants, and the issue of class certification is not before us.

[2] The record is not entirely consistent with respect to the spelling of Mr. Ramchandran's name, as is discussed, *infra*, at note 15.

[3] The "Sigma" enterprises were: Sigma, Inc., Geronimo, Inc., Vol Partners, L.P., and Savid Group.

managers of various commodity pools and thus were able to raise between forty-one and sixty-eight million dollars. The investors were told that the funds would be placed in a commodities trading pool[4] and used to invest in commodities futures and options. Plaintiffs and other investors signed powers of attorney giving Kohli, Ramchandran, and Sigma discretionary authority over investing and trading decisions with respect to their investments. Plaintiffs further alleged that, although Kohli and Ramchandran did, in fact, invest the solicited funds through a variety of futures commodities merchants ("FCMs"), the bulk of those investments failed. However, in the initial phases of the allegedly fraudulent scheme, investors seeking to withdraw their funds or profits were paid with the funds of later investors, thus creating the

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[4] The Ninth Circuit, speaking through Judge Nelson, has pointed out that "[w]hile numerous courts have dealt with the concept of commodity pools in the abstract, few have specifically attempted to define what constitutes a pool." *Lopez v. Dean Witter Reynolds, Inc.*, 805 F.2d 880, 883 (9th Cir.1986). Using as its models the few relatively precise judicial descriptions of the operations of commodities pools, the Ninth Circuit drew the following profile of a pool: "(1) an investment organization in which the funds of various investors are solicited and combined into a single account for the purpose of investing in commodity futures contracts; (2) common funds used to execute transactions on behalf of the entire account; (3) participants share pro rata in accrued profits or losses from the commodity futures trading; and (4) the transactions are traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor." *Id.*

aura of success. The plaintiffs' pleadings characterized this structure as a Ponzi scheme.[5]

Kohli has since pled guilty to federal criminal charges stemming out of these events, and Ramchandran has since filed for bankruptcy. As a result, plaintiffs have undertaken to seek recoupment of their losses elsewhere. Plaintiffs brought suit in the District Court for New Jersey against the FCMs used by Kohli, Ramchandran, and Sigma, as well as the National Futures Association ("NFA")--the futures industry's designated self-regulatory organization[6] --and two of the NFA's officers.

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[5] "The term 'Ponzi scheme' is derived from Charles Ponzi, a famous Boston swindler. With a capital of $150, Ponzi began to borrow money on his own promissory notes at a 50% rate of interest payable in 90 days. Ponzi collected nearly $10 million in 8 months beginning in 1919, using the funds of new investors to pay off those whose notes had come due." *United States v. Masten*, 170 F.3d 790, 797 n. 9 (7th Cir.1999) (quotations and citations omitted).

[6] The NFA is a Registered Futures Association which, pursuant to the Commodities Exchange Act § 17, 7 U.S.C. § 21, functions as the futures industry's self-regulatory organization. It performs screening to determine fitness to become and remain a member of the NFA, establishes and enforces certain rules and standards, audits and investigates members, and conducts arbitration in futures disputes. In order to engage in the business of buying or selling futures contracts for the public, one generally must be a member of the NFA.

Because of the various registration requirements (detailed below) laid down by the Commodities Exchange Act ("CEA"), 7 U.S.C. § 1a, *et seq.*, and state securities law, Kohli, Ramchandran, and Sigma were, so plaintiffs alleged, under a duty to register with the Commodities Futures Trading Commission (the "CFTC"), the Securities and Exchange Commission, and the New Jersey Bureau of Securities; they were also, plaintiffs alleged, obligated to become members of the NFA. Plaintiffs further alleged that Kohli, Ramchandran, and Sigma, in fact, did not register with the several regulatory agencies, or become members of the NFA, and hence that the various FCMs that accepted their business acted improperly. In particular, plaintiffs alleged that the defendant FCMs and their employees failed to inquire into the source of funds in the Sigma accounts or into the CFTC registration status and NFA membership of Kohli, Ramchandran, and Sigma. Plaintiffs contended that had the defendants made such an investigation, they would have discovered that Kohli, Ramchandran, and Sigma were trading in violation both of the registration requirements of the CEA--which mandate that any person associated with a commodity pool operator be registered with the CFTC[7] --and of the

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[7] The CEA provides that: "[i]t shall be unlawful for any person to be associated with a commodity pool operator as a partner, officer, employee, consultant, or agent (or any person occupying a similar status or performing similar functions), in any capacity that involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged, unless such person is registered with the Commission under this chapter as an associated person of such commodity pool operator and such registration shall not have expired, been suspended (and the period

membership requirements of the NFA.[8] Plaintiffs alleged that the FCMs and their employees, by failing to make the necessary investigation, directly violated the CEA, and aided and abetted violations of the CEA;[9] breached certain contracts with the NFA of which appellants were third-party beneficiaries; violated New Jersey's Uniform Securities Law, N.J.S.A. 49:3- 47, *et seq.*; breached fiduciary duties owed to appellants; acted negligently; violated provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961, *et seq.*; committed fraud; engaged in civil conspiracy; and, lastly, violated New Jersey's Consumer Fraud Act, N.J.S.A. 56:8-1, et seq. Thus, of the nine claims asserted against the defendant FCMs, all but three--namely the alleged violations of the CEA (both direct and aiding-and-abetting) and of RICO--sound in state law.

- of suspension has not expired), or been revoked." 7 U.S.C. § 6k(2).

[8] *E.g.*, NFA By-law 1101 provides that "[n]o Member may carry an account or accept an order or handle a transaction in commodities futures contracts for or on behalf of any non-Member of the NFA, or suspended Member, that is required to be registered with the [CFTC] as an FCM, Introducing Broker, Commodity Pool Operator, Commodity Trading Advisor, or Leveraged Transaction Merchant, and that is acting in respect to an account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or other person."

[9] Subsection 22(a)(1) of the CEA, 7 U.S.C. § 25(a)(1), is discussed *infra*, at note 12 and accompanying text.

In addition to alleging that the defendant FCMs failed to conduct inquiries into the source of the funds of Kohli, Ramchandran, and Sigma, plaintiffs claimed that the NFA, as well as two of its officers--individual defendants Thomas Stone and Clarence Delbridge III--were instrumental in enabling Kohli, Ramchandran, and Sigma to operate the alleged Ponzi scheme. As noted above, the NFA is the futures industry's self-regulatory organization. Persons and corporations trading in commodities futures and options are, for practical purposes, required to be members of the NFA, as NFA by-laws preclude members from handling transactions for persons who are required to be registered with the CFTC but are not members of the NFA.[10] Plaintiffs alleged that the NFA, and Stone and Delbridge, acting in bad faith, failed to enforce the rules and by-laws of the NFA prohibiting the FCMs from trading with Kohli, Ramchandran, and Sigma. This bad faith failure, so plaintiffs contended, made Stone, Delbridge, and the NFA civilly liable under subsection 22(b)(2) of the CEA, 7 U.S.C. § 25(b)(2).[11] This is the sole

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[10] *See supra* note 8.

[11] Subsection 22(b)(2) of the CEA provides, in pertinent part:

> (2) A registered futures association that fails to enforce any bylaw or rule that is required under section 21 of this title or in enforcing any such bylaw or rule violates this chapter or any Commission rule, regulation, or order shall be liable for actual damages sustained by a person that engaged in any transaction specified in subsection (a) of this section to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce

federal claim asserted against defendants Stone and Delbridge

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> or enforcement of such bylaw or rule.
>
> (3) Any individual who, in the capacity as an officer, director, governor, committee member, or employee of a contract market, clearing organization, licensed board of trade, or a registered futures association willfully aids, abets, counsels, induces, or procures any failure by any such entity to enforce (or any violation of the chapter in enforcing) any bylaw, rule, regulation, or resolution referred to in paragraph (1) or (2) of this subsection, shall be liable for actual damages sustained by a person who engaged in any transaction specified in subsection (a) of this section on, or subject to the rules of, such contract market, licensed board of trade or, in the case of an officer, director, governor, committee member, or employee of a registered futures association, any transaction specified in subsection (a) of this section, in either case to the extent of such person's actual losses that resulted from such transaction and were caused by such failure or violation.
>
> (4) A person seeking to enforce liability under this section must establish that the contract market, licensed board of trade, clearing organization, registered futures association, officer, director, governor, committee member, or employee acted in bad faith in failing to take action or in taking such action as was taken, and that such failure or action caused the loss.

7 U.S.C. § 25(b)(2).

and the NFA.

Plaintiffs further contended that the NFA by-laws and rules prohibiting the FCMs from trading with Kohli, Ramchandran, and Sigma created contractual obligations, and that plaintiffs, as third-party beneficiaries of those contracts, were entitled, under New Jersey law, to sue the NFA, Stone, and Delbridge. Finally, plaintiffs asserted that the NFA, as well as its officers Stone and Delbridge, had, pursuant to New Jersey law, a fiduciary obligation to plaintiffs, as potential investors, to ensure that the FCMs did not trade with non-members, and that the failure to do so constituted a breach of that fiduciary duty.

Upon defendants' motion to dismiss the complaint, the District Court found that it lacked personal jurisdiction over defendants Stone and Delbridge and that, as to the other defendants, the amended complaint failed to state any claims--whether arising under federal law or state law--upon which relief could be granted. Accordingly, the District Court granted defendants' motion. *See Nicholas v. Stone*, No. 97-860 slip op. at 52 (D.N.J. June 30, 1998).

On appeal, plaintiffs--appellants in this court--argue that the District Court had valid *in personam* jurisdiction over defendants Stone and Delbridge, and that the amended complaint does state claims upon which relief could be granted.

II. Discussion

Appellants have raised numerous issues. Most do not, in our view, require discussion in this opinion because they

have been fully and correctly canvassed in the District Court's comprehensive opinion. There are, however, a few issues arising under section 22 of the CEA, 7 U.S.C.§ 25, which, we think, call for additional analysis. We agree with the District Court's disposition of those issues, but, as will be seen, as to certain aspects of those issues we proceed by a somewhat different route.

A. In personam *jurisdiction*

The District Court commenced its legal discussion by examining whether it had *in personam* jurisdiction over the two individual defendants, Stone and Delbridge, both of whom were domiciled and employed in Illinois. It will be recalled that Stone and Delbridge were (together with the NFA) sued on state law claims of breach of contract and breach of fiduciary duty and also, pursuant to subsection 22(b)(2) of the CEA, 7 U.S.C. § 25(b)(2), on a federal law claim of bad faith failure to enforce NFA rules and by-laws.

The District Court began its analysis by considering whether, as a court sitting in New Jersey, it had jurisdiction over Stone and Delbridge pursuant to New Jersey's long-arm statute which, as the District Court put it, "allows a [New Jersey state] court to exercise personal jurisdiction over non-resident defendants to the fullest extent permitted by the Due Process Clause of the Fourteenth Amendment to the United States Constitution." First, the District Court observed that "jurisdiction over the defendants does not exist simply because they are agents or employees of organizations which presumably are amenable to jurisdiction in this Court." To establish this point, the District Court aptly cited *Keeton v. Hustler Magazine, Inc.*, 465 U.S. 770, 781, 104 S.Ct. 1473,

79 L.Ed.2d 790 (1984). In *Keeton*, the Supreme Court noted that "jurisdiction over an employee does not automatically follow from jurisdiction over the corporation which employs him. . . . Each defendant's contacts with the forum state must be assessed individually." *Id.* at 781 n. 13, 104 S.Ct. 1473. Accordingly, the District Court then "assessed individually" the contacts of Stone and Delbridge with New Jersey:

> In the instant case, plaintiffs have not alleged any contact defendants Delbridge and Stone had with the forum New Jersey. Defendants Delbridge and Stone did not reside in New Jersey, did not visit here, did not own property here or even have any personal contact with the forum state. This Court cannot, therefore, find that defendants have systematic and continuous contacts with New Jersey. Further, defendants Delbridge and Stone never communicated with plaintiffs in New Jersey and never spoke or corresponded with anyone purporting to represent the Sigma entities. Therefore, this court cannot find that defendants Delbridge and Stone took any action by which they purposefully availed themselves of the privilege of conducting activities within the forum state or that would justify haling them into Court in this state. Considering this lack of any allegation that defendants had the requisite minimum contacts in their individual capacities, this Court cannot find that either specific or general jurisdiction exists over them.

The District Court's findings, amply supported by the record, establish that Stone and Delbridge could not, consistently with Fourteenth Amendment due process standards, be subjected to the *in personam* jurisdiction of the District Court with respect to a state law claim. It remains to consider whether the District Court was correct in concluding that Stone and Delbridge were also not amenable to in personam jurisdiction with respect to the federal claim appellants asserted against Stone, Delbridge and the NFA pursuant to subsection 22(b)(2) of the CEA, 7 U.S.C. § 25(b)(2).

Appellants contended in the District Court, and repeat the contention here, that Congress has authorized nationwide jurisdiction for suits arising under section 22. In support of this contention appellants have relied on subsection 22(c) of the CEA, 7 U.S.C. § 25(c). Subsection 22(c) provides as follows:

> (c) **Jurisdiction; statute of limitations; venue; process**
>
> The United States district courts shall have exclusive jurisdiction of actions brought under this section. Any such action shall be brought not later than two years after the date the cause of action arises. Any action brought under subsection (a) of this section may be brought in any judicial district wherein the defendant is found, resides, or transacts business, or in the judicial district wherein any act or transaction constituting the violation occurs. Process in such action may be served

> in any judicial district of which the defendant is an inhabitant or wherever the defendant may be found.

Appellants have argued that Stone and Delbridge are subject to the *in personam* jurisdiction of a federal district court sitting in New Jersey because the third sentence of the quoted subsection expressly provides that an "action . . . may be brought . . . in the judicial district wherein any act or transaction constituting the violation occurs." The District Court rejected the argument: "the above-stated provision is a venue provision, not a jurisdictional one, and as such, does not provide this Court with personal jurisdiction over the individual defendants." We think the District Court was right in construing the third sentence of subsection (c) as directed to venue rather than to *in personam* jurisdiction.

There is a further reason why the third sentence of subsection (c) is of no assistance to appellants. The sentence, by its own terms, addresses actions "brought under subsection (a) of this section [section 22]." Appellants' claim against Stone, Delbridge and the NFA was brought under subsection (b) of section 22.

Finally, appellants invoke the fourth sentence--the concluding sentence--of subsection (c), which provides that "[p]rocess in such action may be served in any judicial district of which the defendant is an inhabitant or wherever the defendant may be found." Here again, however, the syntax of the provision is not spacious enough to accommodate appellants' argument. The phrase "such action" in the fourth sentence of subsection (c) refers back to the immediately preceding sentence--the third sentence--which, as we have

seen, is confined to "[a]ny action brought under subsection (a)." This textual understanding is confirmed by the Senate Report on the Futures Trading Practices Act of 1992, which states, *inter alia*, that the Act "amends [sub]section 22(c) of the Commodities Exchange Act to authorize nationwide service of process in . . . private actions brought under [sub]section 22(a) of the Act," S.Rep. No. 102-22, at 58, *reprinted in* 1992 U.S.C.C.A.N. 3103, 3160.

In sum, the District Court was correct in ruling that, with respect to (a) appellants' state law claims against Stone and Delbridge, and (b) appellants' federal law claim against these two individual defendants, *in personam* jurisdiction was lacking.

B. Liability under Section 22 of the CEA

The District Court dismissed all three federal claims against the defendant FCMs. On appeal, plaintiffs have chosen not to press their claims arising under RICO, thereby limiting themselves to arguing for the revival of the remaining two federal claims, namely, that the FCMs (1) directly violated, and (2) aided and abetted in the violation of, the CEA.

Subsection 22(a)(1) of the CEA, 7 U.S.C. § 25(a)(1),[12] creates a private right of action for "actual

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[12] Subsection 22(a)(1) provides, in full:

> Any person (other than a contract market, clearing organization of a contract market, licensed board of trade, or registered futures association) who violates this chapter

or who willfully aids, abets, counsels, induces, or procures the commission of a violation of this chapter shall be liable for actual damages resulting from one or more of the transactions referred to in subparagraphs (A) through (D) of this paragraph and caused by such violation to any other person–

(A) who received trading advice from such person for a fee;

(B) who made through such person any contract of sale of any commodity for future delivery (or option on such contract or any commodity); or who deposited with or paid to such person money, securities, or property (or incurred debt in lieu thereof) in connection with any order to make such contract;

(C) who purchased from or sold to such person or placed through such person an order for the purchase or sale of--

(i) an option subject to section 6c of this title (other than an option purchased or sold on a contract market or other board of trade);

(ii) a contract subject to section 23 of this title; or

(iii) an interest or participation in a commodity pool; or

(D) who purchased or sold a contract referred to in subparagraph (B) hereof if the violation constitutes a

damages" caused by "[a]ny person . . . who violates this chapter [the CEA] or who willfully aids [or] abets . . . the commission of a violation of this chapter."

i. Liability for direct *violation of the CEA*

A plaintiff may bring a private damage action against "[a]ny person who violates" the CEA when that person stands in one of four relationships with the plaintiff specified in subparagraphs (A) through (D) of subsection 22(a)(1). *See* 7 U.S.C. § 25(a)(1)(A)-(D). Each of the required relationships involves the "person" sued having given advice related to the sale of commodities, or having participated in a transaction related to such sales. Subparagraph (A) imposes liability on the "person" sued when a plaintiff "received trading advice from such person for a fee"; subparagraph (B) imposes liability on the "person" sued when the plaintiff "made through such person" a contract for futures or options thereon, or when the plaintiff deposited money or other property with "such person" in connection with a futures or options contract; subparagraph (C) imposes liability on the "person" sued when the plaintiff purchased from or sold to "such person," or placed through "such person" an order for, certain specified options or commodities contracts, or "an interest or participation in a commodity pool"; and subparagraph (D) imposes liability on the "person" sued when the plaintiff "purchased or sold a contract referred to in

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> manipulation of the price of any such contract or the price of the commodity underlying such contract.

7 U.S.C. § 25(a)(1).

subparagraph (B) if the violation constitutes a manipulation of the price of any such contract or the price of the commodity underlying such contract." (Emphasis added). If the "person" sued has participated in one of the transactions specified in these four subparagraphs, then "such person" can be held liable "for actual damages resulting from one or more of the [specified] transactions . . . and caused by such violation" to the plaintiff. Thus, in order for a plaintiff to sue a defendant for directly violating subsection 22(a)(1), the defendant must (1) have violated the CEA, and (2) stand in an appropriate relationship to the plaintiff with respect to the violative conduct.

Appellants, in their amended complaint, alleged that the FCMs were liable under subsection 22(a)(1) to plaintiffs because of their participation in transactions described in subparagraphs (A), (B), and (C). In particular, appellants alleged that the defendant FCMs gave trading advice to Kohli, who was, so appellants alleged, in some sense, appellants' agent. Similarly, appellants alleged that the FCMs accepted orders of the kind described in subparagraph (B) from Kohli. And finally, appellants contended that the FCMs fell under subparagraph (C) insofar as they permitted Kohli, Ramchandran, and Sigma to sell to appellants interests in commodity pools in violation of the CEA.

Appellants do not contend that the defendant FCMs themselves stood in one of the listed relationships to one or more of the appellants. Instead, appellants argue that the FCMs were directly liable by virtue of a relationship between the FCMs and an agent of the appellants. According to appellants, the conclusion that "Defendant FCMs were dealing directly with Plaintiffs for purposes of violating 7 U.S.C.

§ 25(a)(1)(A)-(D)" follows from the fact that "Kohli, the acknowledged primary violator was the Plaintiff's [sic] agent." The District Court rejected appellants' theory, stating that "[p]laintiffs have provided no authority for allowing a [subsection 22(a)(1)] relationship to be established through an agency theory and there is no indication in the statute indicating the availability of such relief." *Nicholas v. Stone*, slip op. at 24. Without deciding whether or to what extent an agency relationship can ever appropriately be used to establish a subsection 22(a)(1) relationship, we agree with the District Court that the agency theory invoked by appellants does not fit this case. For, as the District Court stated, "allowing such a theory in the instant case, where Kohli, although technically the agent of the plaintiff[s], was clearly not operating in plaintiffs' interests does not seem appropriate." *Id.* Accordingly, the FCMs' transactions with Kohli (and/or Ramchandran and/or Sigma) do not suffice to make them liable to appellants under subsection 22(a)(1).[13]

We turn, then, to appellants' alternate subsection 22(a)(1) theory--namely that the defendant FCMs can be found liable to appellants by virtue of having "aided and abetted" Kohli (and/or Ramchandran and/or Sigma) in violating the CEA.

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[13] Under traditional concepts of agency law, it is the wrong-doing agent of the principal/merchant, not the wrong-doing agent of the victim/investor, who creates liability for the principal. Such is clearly not the case before us. For that reason, we will not comment on a situation in which the wrong-doer is the agent of the merchant rather than of the investor.

ii. Liability for aiding and abetting *violation of the CEA.*

The District Court held that the FCMs could not be liable under subsection 22(a)(1) as aiders and abetters based on its view that, in order to establish aider-and-abetter liability, a defendant must be in one of the four subparagraph-(A)-through-(D) relationships with a plaintiff. *See Nicholas v. Stone*, slip op. at 26-27. The District Court, following its previous decision in *Manley v. Stark & Stark*, Civ. No. 97-524 (D.N.J.), reached this conclusion on the basis of language in subsection 22(a)(1) which appears to treat direct and aider-and-abetter liability in parallel terms. Thus, for example, subsection 22(a)(1) provides, "Any person who violates this chapter or who willfully aids [and] abets . . . the commission of a violation of this chapter shall be liable for actual damages resulting from one or more of the [specified] transactions . . . and caused by such violation to any other person-- (A) who received trading advice from such person for a fee." 7 U.S.C. § 25(a)(1) (emphasis added). Each of the specified transactions in subparagraphs (A), (B), and (C) (the three subparagraphs invoked in the amended complaint) involves activity by "such person"--the antecedent of which appears to be a "person who violates this chapter or who willfully aids [and] abets . . . the commission of a violation."[14]

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[14] Although subparagraph (D) does not expressly refer to "such person," its operative focus is on transactions involving "a contract referred to in subparagraph (B)." We need not, however, address the ingredients of aider-and-abetter liability under subparagraph (D), since as the District Court noted, the amended complaint focused on transactions allegedly falling within subparagraphs (A), (B), and (C).

Accordingly, the syntactic structure of the statute seems to contemplate that "any person" who aids and abets can only be held liable if he is also "such person," *i.e.*, a person who performs one of the acts enumerated in (A), (B), and (C). Under this reading of the statute, it would appear that--just as with direct violators of the CEA--a plaintiff can bring private causes of action against aiders and abetters only if they (1) aid and abet a violation of the CEA; *and* (2) themselves stand in one of the relationships specified in subparagraphs (A), (B), and (C).

The District Court noted that its reading of the statute was consistent with that of the majority of district courts that had discussed the issue of the scope of aiding and abetting liability under subsection 22(a)(1) of the CEA. *See, e.g., In re Lake States Commodities, Inc.*, 936 F.Supp. 1461, 1467 (N.D.Ill.1996) ("[U]nder the plain language of these provisions, a plaintiff must demonstrate that a defendant is one of the 'such persons' listed in § 22(a)(1)(A)(D) in order to hold that defendant liable under the CEA."); *Damato v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 878 F.Supp. 1156, 1161 (N.D.Ill.1995) ("[B]ased upon the plain language of the statute, the court finds that the only persons subject to a private right of action under § 22(a)(1)(C)(ii) of the CEA are the persons who sold or took orders for interests in the commodity pool."); *Davis v. Coopers & Lybrand*, 787 F.Supp. 787, 794 (N.D.Ill.1992) ("By its literal and plain language, the 'such person' specification in CEA § 22(A)(1)(C) limits the statutory remedy to obtaining damages from the persons who sold or took orders for interests in the commodity pool.").

In holding that only "such persons" can be liable as aiders and abetters under subsection 22(a)(1) of the CEA, the District Court expressly rejected the position of the Commodities Futures Trading Commission ("CFTC"), as expressed in an *amicus curiae* brief, which had been filed by the CFTC in the then-pending appeal to the Seventh Circuit in *Damato v. Hermanson* (an appeal from the district court decision in *Damato v. Merrill Lynch, Pierce, Fenner & Smith*, cited *supra*), and which had been presented to the District Court in the present case by plaintiffs. The CFTC, in that brief, had argued that the reading adopted by the district court in *Damato* would unnecessarily limit aider and abetter liability:

> Indeed, requiring that the aider and abettor be "such person" within the meaning of subparagraphs (A) through (D) renders § 22(a) internally inconsistent and does violence to the clear intent of § 22. As indicated above, § 22(a)(1)(A)-(D) defines the persons who are appropriate plaintiffs under the CEA. It also sets forth the damages that may be recovered in a private right of action. It limits recovery to damages caused by the violation and "resulting from one or more of the transactions referred to in subparagraphs (A) through (D)." If "such person" under subparagraphs (A) through (D) referred to the aider and abettor (*i.e.*, if the aider and abettor were required to have the direct relationship with plaintiff), then the only damages recoverable would be those resulting from the transaction between the aider and abettor and the plaintiff. This is

> nonsensical, because the plaintiff's damages result not from the act of the aider and abettor in providing trading advice or selling futures, options or pool interests to the plaintiff, but from the violation itself by the primary violator. . . . Thus, for the language of § 22 to make sense, "such person" in subparagraphs (A) through (D) must refer to the primary violator and not the aider and abettor.

App. at 294-95 (reprinting the *amicus* brief of the CFTC).

Thus, according to the CFTC, "§ 22(a) creates liability for an aider and abettor if (i) he or she assists in a violation of the Act, (ii) the plaintiffs' damages are caused by that underlying violation and (iii) the damages result from one of the transactions set forth in subparagraphs (A)- (D). There is no independent requirement that *both* the primary violator and the aider and abettor deal directly with the plaintiff." *Id.*

After the District Court handed down its order dismissing the amended complaint, but prior to our consideration of this case, the Seventh Circuit handed down its decision in *Damato*. That court rejected the so-called "plain-language" interpretation because it "effectively reads out of the text Congress' specific reference to aiders and abettors in 22." *Damato v. Hermanson*, 153 F.3d 464, 470 (7th Cir.1998). Instead, stating that "[b]y definition, an aider and abettor knowingly contributes to the principal's violation rather than committing an independent violation of its own," the Seventh Circuit adopted the CFTC interpretation of subsection 22(a)(1). *Id.*

In the instant case, appellants urge this court to follow the Seventh Circuit's adoption, in *Damato*, of the CFTC approach to subsection 22(a)(1)'s aiding and abetting language. By contrast, appellees argue, contra *Damato*, that this court should look to the plain language of subsection 22(a)(1), and that--because the FCMs and their employees took no action described in subparagraphs 22(a)(1)(A) through (C)--the FCMs should not be liable as aiders and abetters. We find it unnecessary, however, to resolve this issue at this juncture. For even assuming that we were to follow *Damato*'s adoption of the CFTC approach, the defendant FCMs could, in any event, only be held liable if their conduct met the basic requirements of aiding and abetting. But plaintiffs, in their amended complaint, have not alleged such conduct.

The *Damato* court analyzed the elements of aider and abetter liability under subsection 22(a)(1) as being identical with those contemplated by the federal criminal aider and abetter statute, 18 U.S.C. § 2. *See* 153 F.3d at 473. It therefore concluded that "in order to state . . . a claim against [a defendant] . . . plaintiffs must allege that [the defendant] (1) had knowledge of the principal's . . . intent to commit a violation of the Act; (2) had the intent to further that violation; and (3) committed some act in furtherance of the principal's objective." *Id.* The Seventh Circuit thus recognized that to be an aider and abettor one must (a) have knowledge of the principal's intended violation of the statute, and (b) have the intent to promote that principal's violation. This interpretation is consistent with both the traditional understanding of what is meant by "aiding and abetting" and with the language of subsection 22(a)(1), which contemplates liability for one "who *willfully* aids [and] abets . . . the

commission of a violation" of the CEA. (Emphasis added). We agree with the Seventh Circuit that aiding and abetting in the context of the CEA is congruent with aiding and abetting as defined by 18 U.S.C. § 2. Plaintiffs, however, have not alleged that the defendant FCMs had the required knowledge and guilty intent. Thus, their allegations fall short of stating a claim that defendants aided and abetting in violations of the CEA, regardless of whether such a claim requires allegations that defendants engaged in activity described in subparagraphs (A) through (C) of subsection 22(a)(1).

The principal thrust of the allegations in the amended complaint is that the FCMs did not adequately supervise Kohli, Ramchandran, and Sigma. *See, e.g.*, Amended Complaint, ¶ 104 ("Had the FCMs diligently supervised the activities of . . . Kohli, Chandran[15] and the Sigma Entities, or made any reasonable investigation of the practices of Kohli, Chandran and the Sigma Entities, the FCMs would have discovered Kohli's, Chandran's and the Sigma Entities' fraudulent investment scheme and the material misrepresentations and omissions."). The closest that the amended complaint comes to alleging that the FCMs knew of the misconduct of Kohli, Ramchandran, and Sigma are the statements that the FCMs "were aware, or with required

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[15] "Chandran" and "Ramchandran" are names for the same person. In their amended complaint, appellants used the name "Chandran" to refer to the person called "Ramchandran" in the District Court's opinion. We have followed the District Court, thereby creating a discrepancy between the name we have generally used and the name appearing in quotations from the amended complaint.

minimal due diligence would have discovered" that "Kohli, Chandran and the Sigma Entities were a fiction under the CEA," *id.* at ¶ 128, and that the FCMs "knew or recklessly disregarded facts showing that" Kohli, Ramchandran, and the Sigma Entities were engaged in various activities violative of the CEA. Id. at ¶ 133. In essence, appellants have alleged, at most, that the FCMs acted recklessly, and that they knew or should have known of the violations by Kohli, Ramchandran, and Sigma of the CEA. But these allegations are a far cry from an allegation that the FCMs not only had knowledge of the intent of Kohli and the others to violate the CEA, but, as the Seventh Circuit put it in *Damato*, "the intent to further that violation." 153 F.3d at 473. Accordingly, even if we were to assume *arguendo* the correctness of the CFTC construction of subsection 22(a)(1)--namely, that "for the language of § 22 to make sense, 'such person' in subparagraphs (A) through (D) must refer to the primary violator and not the aider and abettor"--which was adopted by the Seventh Circuit in *Damato*, plaintiffs' amended complaint nonetheless falls short. Therefore, we conclude that the District Court acted properly in dismissing appellants' aiding and abetting claims.

C. Remaining Claims

In addition to the issues discussed above, appellants urge this court to reverse the District Court's determination that each of their state law claims against the FCMs should be dismissed as well. The claims include breach of contract, breach of fiduciary duty, negligence, fraud and civil conspiracy, violation of the New Jersey Consumer Fraud Act, N.J.S.A. 56:8-1, *et seq.*, and violation of the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47, *et seq.*

Additionally, appellants contest the District Court's dismissal of plaintiffs' claims against the NFA. We find the District Court's discussion of these issues to be cogent and persuasive, and therefore adopt the conclusions reached by the District Court with respect to each of these issues.

III. Conclusion

For the foregoing reasons, we will affirm the judgment of the District Court.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

[Filed June 30, 1998]

No. 97-860(AET)

RICHARD NICHOLAS, LYNN NICHOLAS, ROBERT M. BLACKBURN, CHERYL S. BLACKBURN, On Behalf of Themselves and On Behalf of the Class of All Others Similarly Situated, *Plaintiffs,*	)
v.	)
SAUL STONE & COMPANY LLC F/K/A SAUL STONE AND COMPANY, et. al, *Defendants.*	)

ORDER

THOMPSON, Chief Judge

For the reasons stated in this Court's Opinion filed even date herewith;

It is on this 30th day of June, 1998;

ORDERED that the motion of defendants' Delbridge and Stone to dismiss pursuant to Fed. R. Civ. P. 12(b)(2) be and hereby is GRANTED; and it is further,

ORDERED that the motion of defendants GNI Incorporated and GNI Limited to dismiss be and hereby is DENIED AS MOOT; and it is further,

ORDERED that the remaining motions made by defendants to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) be and hereby are GRANTED; and it is further,

ORDERED that defendants' motion for the imposition of sanctions pursuant to Fed. R. Civ. P. 11 be and hereby is DENIED; and it is further,

ORDERED that this case is CLOSED.

/s/_____
ANNE E. THOMPSON, CHIEF JUDGE

NOT FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

[Filed June 30, 1998]

No. 97-860(AET)

RICHARD NICHOLAS, LYNN NICHOLAS, ROBERT M. BLACKBURN, CHERYL S. BLACKBURN, On Behalf of Themselves and On Behalf of the Class of All Others Similarly Situated, *Plaintiffs,*	)
v.	)
SAUL STONE & COMPANY LLC F/K/A SAUL STONE AND COMPANY, et. al, *Defendants.*	)

OPINION

THOMPSON, Chief Judge

This matter comes before the Court on the motions of various defendants to dismiss plaintiffs' complaint pursuant to Fed. R. Civ. P. 12(b)(2) and 12(b)(6) as well as defendants' motion for sanctions pursuant to Fed. R. Civ. P. 11. This

matter was decided after oral argument held on June 9, 1998. For the reasons stated below, plaintiffs' complaint will be dismissed in its entirety and defendants's motion for sanctions will be denied.

BACKGROUND

1. The Parties

The instant action was commenced by certain investors against the named defendants, most of whom are Futures Commission Merchants or broker-dealers with which the Sigma Entities conducted transactions between February of 1991 and April of 1995. The named defendants in the complaint consist of 11 distinct Futures Commission Merchants ("the "FCMs"), the National Futures Association ("NFA") and two individuals who are officers of one of the FCMs and also hold unsalaried positions on certain NFA committees. In addition, plaintiffs seek to assert claims against various unnamed employees of the FCMs. ("FCM EMPLOYEES").

Plaintiffs in this case are a number of individuals who invested money in the "Ponzi" scheme of "Chuckles" Kohli and the Sigma Entities and lost some or all of the funds they invested due to the fraud of the Sigma principals. Plaintiffs are contending that the actions or inactions of defendants in this case are actionable and expose them to liability as well.

The majority of the defendants in this case are Futures Commission Merchants, institutional clearing firms which open and clear customer accounts and hold customer funds

within the commodities industry. Defendant Saul Stone was an Illinois corporation and is now an Illinois limited liability company registered with the Commodity Futures Trading Commission under Section 4f of the CEA as a Futures Commission Merchant. Defendant Saul Stone is engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts and is a clearing member of the Chicago Mercantile Exchange as well as a member of the National Futures Association. Also named as a defendant is John Doe, an individual alleged to be an employee or agent of defendant Saul Stone who acted under the titles of "account executive," "registered representative," "associated person," "Commission broker," and "introducing broker" for Saul Stone and was acting within the actual or apparent scope of his employment or agency.

Defendant First Option was a Delaware corporation registered with the CFTC under Section 4f of the CEA engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant First Options is a clearing member of the Chicago Mercantile Exchange as well as a member of the National Futures Association. Also named as a defendant is Joan Doe, an individual employed by or an agent of defendant acting within the scope of her employment or agency.

Defendant Smith Barney was a Delaware corporation engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Smith Barney is a clearing member of the Chicago Board of Trade and the National Futures Association. Also named as a defendant is Smith Barney's employee and/or agent Joseph Doe acting within the scope of his employment or agency.

Defendant Linnco was an Illinois corporation and is now an Illinois limited liability company engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Linnco is a clearing member of the Chicago Mercantile Exchange as well as a member of the National Futures Association. Also named as a defendant is Linnco's employee and/or agent Jane Doe.

Defendant GNI, Incorporated was an Illinois corporation registered with the CFTC under Section 4f and engaged in the business of brokerage in connection with the sale of commodities and commodity futures. GNI is a clearing member of the Chicago Board of Trade as well as a member of the NFA. Defendant GNI Limited was a foreign broker within the meaning of 17 CFR Sections 15 through 17, engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Plaintiffs contend that GNI Incorporated and GNI Limited are part of a group or family of companies that hold themselves out to the public and operate under the designation of GNI for all purposes. Also named as a defendant is GNI's employee and/or agent "Jack Doe".

Defendant Dean Witter was a Delaware corporation registered with the CFTC under Section 4f of the CEA as a FCM and is engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant Dean Witter is a clearing member of the Chicago Mercantile Exchange as well as a member of the NFA. Also named as a defendant is Jeff Doe, an employee and/or agent of defendant Dean Witter.

Defendant ING was an Illinois corporation registered with the CFTC under Section 4f of the CEA as a FCM and is engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant ING is a clearing member of the Chicago Board of Trade as well as a member of the NFA. Also named as a defendant is Jean Doe, an employee and/or agent of defendant ING.

Defendant Merrill was a Delaware corporation registered with the CFTC under Section 4f of the CEA engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant Merrill is a clearing member of the Chicago Board of Trade as well as a member of the NFA. Also named as a defendant is James Doe, an employee and/or agent of Merrill.

Defendant Prudential was a Delaware corporation registered with the CFTC under Section 4f of the CEA and engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant Prudential is a clearing member of the Chicago Board of Trade as well as a member of the NFA. Also named as a defendant is Jill Doe, an employee and/or agent of defendant Prudential. ¶ 25.

Defendant Rosenthal was an Illinois corporation and is now an Illinois limited partnership registered with the CFTC under Section 4f of the CEA and engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant Rosenthal is a clearing member of the Chicago Mercantile Exchange as well as a member of the NFA. Also named as

a defendant is Jill Doe, an employee and/or agent of defendant Rosenthal. ¶ 27.

Defendant E D & F was a Delaware corporation registered with the CFTC under Section 4f and engaged in the business of brokerage in connection with the sale of commodities and commodity futures contracts. Defendant E D & F is a clearing member of the Chicago Mercantile Exchange as well as a member of the NFA. Also named as a defendant in this action is Joel Doe, an employee and/or agent of defendant E D & F. ¶ 29.

Defendants Saul Stone, First Options, Smith Barney, Linnco, GNI Incorporated, Dean Witter, ING, Merrill, Prudential, Rosenthal and E D & F are all registered with the CFTC as a FCM and are referred to collectively as "FCMs". Defendants John Doe, Joan Doe, Jack Doe, Joseph Doe, Jane Doe, Jake does Jeff Ode, Jean Doe, James Doe, Jill Doe, and Joel Doe each of whom are employees or his or her respective defendant FCMs are collectively referred to as FCM EMPLOYEES.

Defendant the National Futures Association is a Delaware corporation which is a Registered Futures Association pursuant to 7 U.S.C. § 17 of the CEA that transacts business as the future's industry's self-regulatory organization. It was established in 1976 to become the futures industry's self-regulatory organization under 7 U.S.C. § 21. As a self-regulatory organization, the NFA performs screening to determine fitness to become or remain an NFA Member, establishes and enforces rules and standards, audits and investigates members and conducts arbitration of futures related disputes. No person or firm may engage in any

business which involves buying or selling futures contracts for the public without being an NFA member. ¶ 34. Plaintiffs in this case are seeking to recover from defendant NFA alleging that the NFA breached contractual (Count Two) and fiduciary (Count VII) duties which it owed to these plaintiffs and that the NFA "acted in bad faith in failing to enforce its own Bylaws and Rules as set forth in the NFA manual pursuant to 7 U.S.C. § 21(b)(8). (Count III)

Also named as defendants in this action are Clarence Delbridge and Thomas Stone. Defendant Clarence Delbridge, a principal of Saul Stone, is a member of the NFA as an associated person and an elected member of the Regional Business Conduct Committees of the NFA for the Central Region. ¶ 32. Defendant Thomas Stone was employed as Chairman of the Board of Saul Stone, is a member of the NFA as a Floor Broker and serves as an elected member of the Advisory Committee of the NFA for Futures Commission Merchants. ¶ 33. Plaintiffs contend that in their positions, Delbridge and Stone acted as agents for both Saul Stone and the NFA.

Mr. Stone is Chairman of the Board of Saul Stone & Co. He has been employed by Saul Stone for thirty two years and has worked out of Saul Stone's offices at 30 South Wacker Drive, Chicago, Illinois since 1982. He has been a domiciliary of Illinois and has lived in Illinois for at least thirty one years.

Mr. Delbridge is an Executive Vice-President of Saul Stone & Co. He has been employed by Saul Stone since 1987 and has worked out of Saul Stone's offices at 30 South Wacker Drive in Chicago, Illinois during his employment.

Mr. Delbridge has been a domiciliary of Illinois since at least 1987. From February 1988 until March 15, 1995, Mr. Delbridge was a member of the NFA's Business Conduct Committee for the Central Region which was comprised of the following states: Alabama, Arkansas, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Michigan, Mississippi, Ohio, Tennessee, Texas and Wisconsin. The NFA Business Conduct Committee for the Cental Region reviewed disciplinary actions brought to their attention by NFA staff members for improprieties alleged to have occurred in the Central Region. On March 15, 1994 the NFA restructured the Business Conduct Committee and its function. As of that date, the Committee is no longer engaged in fact-finding or imposing discipline but rather its role is now limited to determining whether regulatory actions should be brought against those members before the Hearing Committee. The Hearing Committee is now the body which conducts fact-finding and imposes discipline.

2. Other Relevant Entities and Individuals

Sigma, Inc. is a Delaware corporation that was engaged in the solicitation, pooling and investment of clients' funds in the securities, commodities futures and options markets.

Chuckles Kohli was one of two directors and a principal officer of Sigma and other related enterprises. On March 6, 1996, Kohli plead guilty to federal charges of commodities fraud, wire fraud and income tax evasion. United States v. Chuckles Kohli, Criminal No. 96-132(AET).

Ramchandran was also one of two directors and a principal officer of Sigma. He is currently the subject of investigation by the United States Attorney's Office.

3. Plaintiffs' Allegations

A. General Allegations

The plaintiffs' Amended Complaint charges generally, that from as early as 1989 and until April 12, 1995, Kohli and Ramchandran, the sole shareholders and officers of the Sigma entities, solicited, on Sigma's behalf, approximately $41 million from 400 investors by falsely holding themselves out as experienced commodities and options traders. The majority of these funds was placed with the defendants. The Amended Complaint alleges that Kohli and Ramchandran solicited these funds from members of the public, including plaintiffs, to invest in commodities for future delivery as well as other commodities, future contracts and commodity options. Kohli and Ramchandran conducted this activity using the business names of Sigma, Inc.; Geronimo, Inc.; Vol Partners, L.P.; and Savid Group. The investor plaintiffs were informed their funds would be pooled and used to trade in the currency and other markets and signed Powers of Attorney giving Kohli, Ramchandran and the Sigma Entities discretionary authority over investing funds and trading decisions. Throughout the relevant time period, Kohli, Ramchandran and Sigma were engaged in fraudulent activity commonly referred to as a "Ponzi" scheme. A Ponzi scheme is one in which early investors who seek to withdraw their funds or their purported profits are paid with funds invested by subsequent investors, and ultimately the later funds are lost due to the fraud of the principals.

The Amended Complaint alleges generally, with respect to the named defendants, that Sigma opened one or more accounts with each of the defendants and entered trades through these accounts. The defendants aided in the execution of trades and sent confirmations and monthly account statements reflecting the transactions which had been executed. The Amended Complaint alleges that defendants never conducted due diligence or made inquiries with respect to the financial condition of Sigma or the source of the deposited funds. The Amended Complaint further alleges that the defendants never inquired into the status of the CFTC registration and NFA membership of Kohli, Ramchandran or Sigma and that defendants 'knew or should have known of the "Ponzi" scheme being perpetrated by Kohli and Ramchandran. The Amended Complaint asserts that as a result of the fraudulent "Ponzi" scheme, in which defendants participated, the investor plaintiffs lost approximately $55 million.

More specifically, plaintiffs allege that along with Kohli, Chandran and the Sigma Entities, the defendants "knowingly, with intent to deceive, with reckless disregard for the truth or conscious avoidance of the truth, in bad faith, withheld and/or failed to disclose" to plaintiff investors the following: 1) that Kohli, Chandran and the Sigma Entities were not appropriately registered or licensed; 2) that Kohli, Chandran and the Sigma Entities were not members of the NFA; 3) that the securities solicited and sold to plaintiffs were not registered as securities under state or Federal laws or regulation; 4) that Kohli and Chandran were not investing all funds obtained from the plaintiffs in commodity futures contracts or other legitimate investments, but were also using said funds to pay phony "profits" and for other business and

personal purposes; 5) that defendant FCMs and FCM EMPLOYEES earned commissions on every commodity futures contract trade made through the FCMs; 6) that defendant FCMs had not followed the rules and regulations of the CFTC and the NFA Manual concerning disclosure of information as required to be made to third party investors; 7) that some of the plaintiffs' funds were going to repay defendant FCMs for debit balances; and 8) that Kohli and Chandran had very little knowledge about commodity futures trading, did not maintain accurate and complete records, did not comply with the rules and regulations of the CFTC and the NFA Manual and created fictitious account statements. ¶ 90

B. Sigma's Relationship with Defendants

Plaintiffs' Amended Complaint alleges that Kohli, Chandran and the Sigma Entities approached each of the defendant FCMs some time between January 1, 1989 and April 12, 1995 to place orders to purchase or sell futures contracts. ¶ 64. Plaintiffs further allege that, "Once Kohli, Chandran and the Sigma Entities secured the initial core of plaintiff investors, they induced additional persons to invest through the Sigma Entities' false appearance of legitimacy. The appearance of legitimacy stemmed from the fact that although only a properly registered and licensed FCM or CPO may hold customers' money in an omnibus account, the FCMs allowed the Sigma Entities to deposit customers' funds in an account with the FCMs even though they were not registered as an FCM or a CPO." ¶ 65

Plaintiffs contend that during the relevant time period, the FCM defendants opened Special Accounts for investment

in commodities for Kohli and Chandran through business names of Sigma, Inc., Geronimo, Inc., Vol Partners, L.P. and Savid Group and these Special Accounts were all corporate and/or partnership accounts whose forms were completed by Kohli. ¶¶ 68, 69. Plaintiffs contend that in connection with opening a new account, the FCMs should have required the Sigma Entities to submit certain documentation and information, including financial statements and/or information of the principals of the company as well as certification indicating who from the company was authorized to conduct trades and transfers of money in and out of the account, but that the defendant FCMs failed to take such action. ¶ 69.

According to plaintiffs' Amended Complaint, the financial information which Kohli provided to the FCMs on account forms was inconsistent with the magnitude of the trading activity conducted in the accounts and the substantial losses sustained in the accounts over the relevant period and the volume of trading and trading losses as sustained in the accounts frequently exceeded the equity in the accounts and the net worth of the Sigma entities as shown on the financial information submitted to the defendant FCMs. ¶ 70. Plaintiffs assert that "in light of the material discrepancies between the reported financial information of the Sigma Entities, the volume of trading conducted in the accounts, the substantial losses which were being sustained in the accounts and the number of different individuals who were listed with trading authority on the accounts, defendant FCMs were aware that the accounts were being operated as commodity pools comprised of funds solicited from third party investors, therefore requiring registration pursuant to CFTC regulations and NFA rules." Plaintiffs assert that the failure of the FCMs

to perform minimal diligence with regard to the background of Kohli, Chandran and the Sigma entities was reckless and without regard for the truth. ¶ 71.

At various times, the accounts of Kohli and Chandran under the business names of the Sigma Entities carried lower balances with the defendant FCMs than necessary to meet the withdrawal demands of the plaintiffs and at times carried negative balances. According to plaintiffs, at these points Kohli and Chandran had to solicit additional funds from new investors so that the new investors' money could be placed in the accounts, thus concealing from the plaintiffs the true diminished value of their accounts. ¶ 85. Plaintiffs contend that defendant FCMs and FCM EMPLOYEES knew or should have known that most of the funds in the accounts of the Sigma Entities during the period of January 1, 1989 and April 12, 1995 had been obtained by Kohli and Chandran from third party investors by false pretenses and without proper regard to the requirements of the CEA, CFTC Regulations and the NFA Manual concerning commodity pool investments. ¶ 86. Plaintiffs also contend that defendants knew or should have known that the account of the Sigma Entities contained funds that Kohli, Chandran and the Sigma Entities were soliciting from the plaintiff class members who were innocent investors who believed their money was being pooled legally and properly invested in the commodities market. ¶ 88.

C. Disclosure Documents, Registrations Requirements and "Due Diligence"

Plaintiffs' Amended Complaint also contains allegations that the defendants failed to ascertain whether the

proper documents were filed or delivered to plaintiffs. Plaintiffs contend that the defendant FCMs and FCM EMPLOYEES never received from the plaintiffs an acknowledgment for receipt of the required Disclosure Document pursuant to 17 CFR § 4.24 from Kohli, Chandran and the Sigma Entities, nor a Written Statement explaining why a Disclosure Document is not required pursuant to NFA Compliance Rule 2-8(e). ¶ 77. Plaintiffs also assert that the FCMs and FCM EMPLOYEES did not confirm delivery of the required Disclosure Document by Kohli, Chandran and the Sigma Entities pursuant to 17 CFR § 4.21 of the CFTC Regulations and NFA Compliance Rule 2-13. ¶ 79. Plaintiffs also allege, upon information and belief, that the defendant FCMs and FCM EMPLOYEES did not deliver to plaintiffs the required Disclosure Document in the form mandated by 17 CFR § 1.55 and NFA Compliance Rule 2-26. ¶ 83.

Plaintiffs claim that the defendant FCMs and FCM EMPLOYEES failed to investigate and know their customers and failed to perform minimum due diligence by not contacting the CFTC and NFA to gather information regarding Kohli, Chandran and the Sigma Entities as the agents for the plaintiffs pursuant to NFA Compliance Rule 20-8a9e. ¶ 81. Plaintiffs further contend that the defendant FCMs and FCM EMPLOYEES violated the NFA Articles of Incorporation, Article III, § 1(f) and NFA Bylaw 1101 by carrying accounts, accepting and handling transactions in commodity futures contracts on behalf of non-members of the NFA who were required to be registered with the CFTC and transacting business with an unregistered person pursuant to the statutory makeup of 7 U.S.C. Sections 6d., 6e., 6k., and 6n. ¶ 82.

D. Allegations Against Saul Stone

Plaintiffs contend that defendant Saul Stone in particular knew or had reason to know of the illicit activities of Kohli, Chandran and the Sigma Entities because of prior involvement in similar "Ponzi" schemes. According to plaintiffs, in September of 1982 defendant Saul Stone received actual notice of a similar "Ponzi" scheme of fraud and deceitful practices perpetrated through and with the assistance of Saul Stone's offices and personnel. Plaintiffs contend that this put Saul Stone on notice as to the likelihood and foreseeability of such "Ponzi" schemes developing when it did not diligently supervise the activities of its personnel and when it did not comply with the rules and regulations of the CFTC, CME and NFA. ¶ 93. Further, in June of 1985, Saul Stone also received actual notice of a "Ponzi" scheme perpetrated through and with the assistance of its offices and personnel. ¶ 94. Plaintiffs contend that the failure of defendant Saul Stone and the other defendant FCMs to properly and diligently train, manage, supervise and investigate the activities of their respective FCM EMPLOYEES as Well as Kohli, Chandran and the Sigma Entities, facilitated the occurrence of the activities complained of. ¶ 95.

E. NFA Failure to take Action

Plaintiffs assert that despite the fact that defendant FCMs and FCM EMPLOYEES carried accounts, accepted orders and handled transactions on behalf of parties not members of the NFA – no disciplinary action has been taken by the defendant NFA and no thorough, diligent and vigorous investigative action has been initiated by the NFA concerning

the management and conduct of the FCMs and FCM EMPLOYEES. Further, plaintiffs contend that the NFA knew or should have known that defendant FCMs were failing to submit certain forms as required by 17 CFR § 17.01 and thus knew or should have known that Kohli was illegally acting as a Third Party Account Controller and took no action. ¶ 102. According to plaintiffs' Amended Complaint, the NFA received substantial income due to the trades and therefore, "due to the high volume of income generated by defendant FCMs for the benefit of the NFA, the NFA had an ulterior motive with little or no motivation to conduct a thorough and vigorous disciplinary investigation of the FCMs." ¶ 106

F. FCM Failure to Cease Trading with Sigma

Plaintiffs similarly contend that defendant FCMs failed to cease trading with the Sigma Entities, despite knowledge of its fraudulent activities, because of commissions obtained through such trading. Plaintiffs assert that at various times beginning in 1989, the defendant FCMs authorized and permitted their employees to hold themselves out as agents of their employers and as such accepted orders from Kohli, Chandran and the Sigma Entities for commodity futures transactions for which they received substantial commissions. ¶ 103. Plaintiffs contend that there were approximately 10,000 trades per month which were excessive under the circumstances, contrary to the best interests of investors and constituted "churning" of the account and due to the high volume of commissions generated by FCM EMPLOYEES the FCMs had little or no motivation to conduct a thorough and vigorous investigation of FCM EMPLOYEES and the activities of Kohli, Chandran and the Sigma Entities. ¶ 103.

G. Improper Transfers

Plaintiffs also contend that $710,000 in the Sigma Entities' Special Accounts at certain of the defendant FCMs were improperly transferred by those defendant FCMs upon instructions from Kohli to personal accounts maintained by Kohli. ¶ 73. Plaintiffs contend that a total of $590,000.00 was transferred from at least one account in the name of Geronimo at defendant Merrill Lynch to Kohli's personal account at Charles Schwab or Dean Witter. ¶ 74. Further, according to plaintiffs, $80,000 was transferred from a Merrill account in the name of Geronimo to Kohli's personal joint account with his wife at Schwab. ¶ 76. Plaintiffs also contend that a transfer in the amount of $40,000 was made from a Prudential account in the name of Sigma to Kohli's personal joint account with his then wife at Schwab. ¶ 76.

H. Involvement of FCM EMPLOYEES

Plaintiffs allege, as stated above, that as a result of the "Ponzi" scheme perpetrated by the Sigma Entities, they lost $ 55 million. Plaintiffs allege, upon information and belief that as of February 28, 1995, reports issued by Kohli and Chandran showed in the aggregate that the commodity pools operated by Kohli and Chandran had assets totaling at least $68 million and of this amount $55 million was lost through trading activities, and an additional $5 million was spent by Kohli and Chandran and $11.6 million was returned to investors. ¶ 60. Plaintiffs allege, upon information and belief that a portion of the $5 million spent by Kohli and Chandran was used to entertain FCM EMPLOYEES including employees of defendant Merrill Lynch at a December 1994 Florida golf trip and employees of defendant First Options at

golf outings, football games and other events in either New Jersey or Las Vegas in 1994. ¶ 61.

Further, with regard to the aforementioned $5 million of investor funds plaintiffs assert that some of the funds were used to pay for personal trips to Florida by Steve Kaczmer, who was employed first by defendant Linnco and then by defendant First Options. ¶ 62. Further, plaintiffs contend that the funds were used to pay a $10,000 per month salary to Kaczmer who, while trading during the day at First Options, traded at night for the Sigma Entities from his home terminal. Kaczmer also received from Kohli the sum of $60,0000 in the form of a "loan" of which only $40,000 was repaid; the remaining balance was "forgiven" by Kohli. ¶ 63.

I. Plaintiffs' Complaint

As a result of the above stated factual scenario, on February 13, 1997 the investor-plaintiffs filed an eleven count Complaint against the named defendants. The following causes of action were asserted in the original Complaint: Count One alleges a violation of the Commodities Exchange Act; Count Two alleges a breach of contract under New Jersey common law; Count Three alleges bad faith failure to enforce NFA rules; Count Four alleges a violation of the New Jersey Uniform Securities Law; Count Five alleges violations of the Securities Act of 1933, Count Six alleges violations of the Securities Act of 1934; Count Seven alleges a breach of fiduciary duty; Count Eight asserts negligence; Count Nine alleges a violation of RICO; Court Ten alleges fraud and civil conspiracy; and Court Eleven alleges a violation of the New Jersey Consumer Protection statute. On November 24, 1997, plaintiffs filed their First Amended Class Action Complaint.

The Amended Complaint contained the same claims as the original with the exception of Counts Five and Six, which were omitted.

Defendants now move to dismiss plaintiffs' complaint in its entirety for a variety of reasons. Defendant have also moved for the imposition of sanctions pursuant to Fed. R. Civ. P. 11.

DISCUSSION

1. Personal Jurisdiction - Defendants Delbridge and Stone

The only specifically identified individual defendants in the instant case are Clarence Delbridge and Thomas Stone. Mr. Delbridge and Mr. Stone are named in the claims for breach of contract, bad faith failure to enforce NFA rules, and breach of fiduciary duties. According to plaintiffs' Amended Complaint, defendants Delbridge and Stone's wrongdoing stems from their dual capacity as (a) executives of Saul Stone & Co., and (b) members of certain National Futures Association committees. The Amended Complaint alleges that the individual defendants are liable to plaintiffs because they failed to detect and report to the NFA various misdeeds of non-parties.

The individual defendants have not consented to the exercise of personal jurisdiction by this Court and they contend that there are no relevant contacts between either Mr. Delbridge or Mr. Stone and this forum and the fact that they are employed by Saul Stone & Company or serve on NFA committees does not create personal jurisdiction over them.

They have moved to dismiss the claims against them pursuant to Fed. R. Civ. P. 12(b)(2). As their motion raises issues of this Court's jurisdiction, this Court will address it as an initial matter.

When a defendant challenges the court's in personam jurisdiction, the plaintiff must show that the defendant had sufficient contacts with the forum. Time Share Vacation Club v. Atlantic Resorts. Ltd., 735 F.2d 61, 63 (3d Cir. 1984). Where the issue is presented in a motion to dismiss, the Court must accept as true the allegations in the complaint and resolve disputed issues of fact in favor of the plaintiff. Carteret Savings Bank v. Shushan, 954 F.2d 141, 142 n. 1 (3d Cir.) cert. denied, 113 S.Ct. 61 (1992).

Generally, the law of the state in which the district court sits governs whether the district court may assert personal jurisdiction over a nonresident defendant. Fed. R. Civ. P. 4(e); Dent v. Cunningham, 786 F.2d 173, 175 (3d Cir. 1986). A Federal Court sitting in New Jersey, therefore may exercise jurisdiction over any person who would be subject to the jurisdiction of the courts of the state of New Jersey. Fed. R. Civ. P. 4(e); North Penn Gas Co. v. Corning Natural Gas Corp., 897 F.2d 687, 689 (3d Cir.) cert. denied, 498 U.S. 847 (1990). New Jersey's long arm statute, Civil Practice Rule 4:4-4(c)(2), allows a court to exercise personal jurisdiction over non-resident defendants to the fullest extent permitted by the Due Process Clause of the Fourteenth Amendment to the United States Constitution. DeJames v. Magnificence Carriers, Inc., 654 F.2d 280, 284 (3d Cir.) cert. denied, 454 U.S. 1085 (1981).

For the exercise of jurisdiction to conform with the Fourteenth Amendment, it must be shown that a defendant has had "minimum contacts" with the forum state, so that it would be "'reasonable . . . to require the corporation to defend the particular suit which is brought there.'" World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 291-292 (1980) (quoting International Shoe Co. v. State of Washington Office of Unemployment, 326 U.S. 310, 317 (1945)). There are two grounds for asserting in personam jurisdiction. First, the court may find that the defendant has had sufficiently continuous and systematic contacts with the forum to support "general jurisdiction." Helicopteros Nacionales de Columbia, S.A. v. Hall, 466 U.S. 408, 414 n.8 (1983). Second, if the cause of action is related to or arises out of the defendant's activities within the forum, the court may exercise "specific jurisdiction." Id.

Personal jurisdiction over the defendants does not exist simply because they are agents or employees of organizations which presumably are amenable to personal jurisdiction in this Court. Keeton v. Hustler Magazine, Inc., 465 U.S. 770, 781 (1984). The law is clear that a corporate officer or agent who has contact with the forum state only with regard to the performance of corporate duties does not thereby become subject to jurisdiction in his or her individual capacity. Forsythe v. Overmyer, 576 F.2d 779, 783-84 (9th Cir.) cert. denied, 439 U.S. 864 (1978); Arkansas Rice Growers v. Alchemy Industries, Inc., 797 F.2d 565 (8th Cir. 1986). Further, a person generally acting as an agent on behalf of a corporation is not individually subject to personal jurisdiction merely based on his actions in a corporate capacity. TJS Brokerage & Co. v. Mahoney, 940 F.Supp. 784, 788-89 (E.D. Pa. 1996). Each defendant's contacts with the forum

state must, therefore, be evaluated individually. See Rush v. Savchuk, 444 U.S. 320, 332 (1980). See also PSC Prof. Serv. Group v. American Digital Systems, 555 F.Supp. 788, 791 n.5 (E.D. Pa. 1983) (It is well settled that, absent allegations that the corporate shield is a sham, jurisdiction over the corporation does not subject officers, directors and shareholders of the corporation to personal jurisdiction). Therefore, this Court must assess the contact of defendants Delbridge and Stone with the forum state in their individual capacities.

In the instant case, plaintiffs have not alleged any contact defendants Delbridge and Stone had with the forum New Jersey. Defendants Delbridge and Stone did not reside in New Jersey, did not visit here, did not own property here or even have any personal contact with the forum state. This Court cannot, therefore, find that defendants have systematic and continuous contacts with New Jersey. Further, defendants Delbridge and Stone never communicated with plaintiffs in New Jersey and never spoke or corresponded with anyone purporting to represent the Sigma entities. Therefore, this court cannot find that defendants Delbridge and Stone took any action by which they purposefully availed themselves of the privilege of conducting activities within the forum state or that would justify haling them into Court in this state. Considering this lack of any allegation that defendants had the requisite minimum contacts in their individual capacities, this Court cannot find that either specific or general jurisdiction exists over them.

As a final matter, this Court notes that plaintiffs have argued that subsection 25(c) of the Commodity Exchange Act provides this Court with personal jurisdiction over defendants

Delbridge and Stone. Subsection 25(c) of the CEA provides, in pertinent part, that "any action brought under subsection (a) of this section may be brought in any judicial district wherein a defendant is found, resides, or transacts business, or in the judicial district wherein any act or transaction constituting the violation occurs." 7 U.S.C. § 25(c). However, defendants contend, and this Court agrees that the above-stated provision is a venue provision, not a jurisdictional one, and as such, does not provide this Court with personal jurisdiction over the individual defendants. Therefore, while venue may be appropriate in the District of New Jersey -- without an independent basis of personal jurisdiction over defendants, the above stated venue provision cannot provide this Court with such jurisdiction.

2. Fed. R. Civ. P. 12(b)(6)

The court cannot dismiss an action under Rule 12(b)(6) unless it appears beyond doubt that the plaintiff can prove no set of facts in support of the claims as plead which would entitle the plaintiff to relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957). The factual allegations raised in the complaint must be assumed to be true. Jenkins v. McKeithen, 395 U.S. 411, 421 (1969); Kost v. Kozakiewicz, 1 F.3d 176, 183 (3d Cir. 1993). The complaint should be construed liberally in the plaintiff's favor, giving that party the benefit of all fair inferences which may be drawn from the allegations. Wilson v. Rackmill, 878 F.2d 772, 775 (3d Cir. 1989). "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." Scheuer v. Rhodes, 416 U.S. 232, 236 (1974).

3. Defendants GNI Incorporated and GNI Limited

This Court notes that defendants GNI Incorporated and GNI Limited filed motions to dismiss the Complaint with regard to them, however as the parties have stipulated to the dismissal of these defendants, and an Order to that effect has been entered, this Court will deny the motions of GNI Incorporated and GNI Limited as moot.

4. Count One: The Commodities Exchange Act

Count One of plaintiffs' Amended Complaint alleges a violation of the Commodities Exchange Act by defendant FCMs and FCM employees, asserting that these defendants carried accounts, accepted orders and handled commodity futures contracts for Kohli, Chandran and the Sigma Entities, all non-Members of the NFA, exceeding their authority, as agents for the plaintiffs. ¶ 127. Plaintiffs further contend that Kohli, Chandran and the Sigma Entities were a fiction under the CEA of which the FCMs and FCM employees were aware, or with required minimal due diligence would have discovered. ¶ 128. In Count One of the Amended Complaint, plaintiffs contend that defendants were both primary violators of the Commodity Exchange Act and aiders and abettors of Commodity Exchange Act violations.

Section 25 of the Commodity Act provides, in pertinent part, that:

> Any person (other than a contract market, clearing organization of a contract market, licensed board of trade, or registered futures association) who violates this chapter or who willfully aids, abets, counsels, induces, or procures the commission of a violation of this

chapter shall be liable for actual damages resulting from one or more of the transactions referred to in subparagraphs (A) through (D) of this paragraph and caused by such violation to any other person --

> (A) who received trading advice from such person for a fee;
>
> (B) who made through such person any contract of sale of any commodity for future delivery (or option on such contract or any commodity); or who deposited with or paid to such person money, securities, or property (or incurred debt in lieu thereof) in connection with any order to make such contract;
>
> (C) who purchased from or sold to such person or placed through such person an order for the purchase or sale of--
>
> > (i) an option subject to section 6c of this title (other than an option purchased or sold on a contract market or other board of trade);
> >
> > (ii) a contract subject to section 23 of this title, or

> (iii) an interest or participation in a commodity pool; or
>
> (D) who purchased or sold a contract referred to in subparagraph (B) hereof if the violation constitutes a manipulation of the price of any such contract or the price of the commodity underlying such contract.

7 U.S.C. § 25(a)(1)(A)-(D). Section 25(a)(2) states that, except under certain circumstances not relevant here, "the rights of action authorized by this subsection . . . shall be the exclusive remedies under this chapter available to any person who sustains loss as a result of any alleged violation of this chapter." 7 U.S.C. § 25(a)(2). The Commodity Act also provides at 7 U.S.C. § 13c(a) that:

> Any person who commits, or willfully aids abets, counsels, commands, induces, or procures the commission of a violation of any of the provision of [the Commodity Act], or any of the rules, regulations, or orders issued pursuant to [the Commodity Act], . . . may be held responsible for such violations as a principal.

Therefore, the CEA creates a private cause of action in limited circumstances for both direct violations of the CEA and aiding and abetting violations of the CEA.

A. Direct Violations

Plaintiffs contend that defendants are primary violators of subparagraphs (A), (B) and (C) of 7 U.S.C. § 25(a)(1). Plaintiffs first contend that the defendant FCM's provided trading advice to plaintiffs for a fee in violation of subparagraph (A) because they regularly advised the Sigma entities what they could or could not trade. More specifically, plaintiffs contend that defendants gave advice to guide plaintiffs accounts around margin requirements and to allow Kohli to maximize the number of trades in order to maximize their own commission fees." Plaintiffs contend that this places defendant FCM in the shoes of "such person" listed in subparagraph (A).

As the FCM defendants had no contact with the investor plaintiffs, there is no allegation in the instant case that defendants directly gave plaintiffs advice, rather plaintiffs allege an "agency" theory in which defendants' alleged acts of giving trading advice to Kohli, who is alleged to be plaintiffs' agent, constitutes the giving of advice to plaintiffs in satisfaction of subparagraph (A). Plaintiffs have provided no authority for allowing a section 25 relationship to be established through an agency theory and there is no indication in the statute indicating the availability of such relief. Further, this Court notes that allowing such a theory in the instant case, where Kohli, although technically the agent of the plaintiff was clearly not operating in plaintiffs' interest does not seem appropriate.

Subparagraph B of Section 25(a)(1) which relates to contracts for sale of commodities for future delivery, will support a cause of action if the plaintiff made the contract of sale through the defendant or deposited with or paid to the defendant money, securities or property in connection with

the order to make such a contract. 7 U.S.C. § 25(a)(1)(B); Grossman v. Citrus Assoc. of the New York Cotton Exchange, Inc., 706 F.Supp. 221, 230 (S.D.N.Y. 1989). Plaintiffs also contend that defendants accepted orders from plaintiffs for futures and options contracts and/or accepted deposits from plaintiffs in violation of subparagaph (B). This argument is based on the theory that as Kohli was the agent of the plaintiffs, accepting trades from him was the equivalent of accepting trades from plaintiffs in violation of 7 U.S.C. § 25(a)(1)(B). For the reasons stated above, this court finds that plaintiffs have failed to establish a relationship under Subparagraph B of § 25.

Subparagraph C permits an individual to maintain a private action against persons who purchased an interest or participation in a commodity pool or sold such an interest to that pool. Plaintiffs contend that defendants created pool interests by allowing the Sigma entities to trade without margin and that undermargined positions were eventually transferred to plaintiff and that "this overt act of ignoring required margins places defendant FCM's in the position of both primary violator of subparagraph C and as a aiders and abettors of such a violation." Plaintiffs do not allege that the FCM defendants sold them any such interest, but rather admit that the interest or participation in commodity pools were sold to them by Kohli, Chandran and the Sigma entities. As plaintiffs again rely on an agency theory, this Court does not find that plaintiffs have stated the required relationship under Subparagraph C.

As plaintiffs have failed to state any of the required relationships under § 25(a), their claim for a direct violation of the CEA must be dismissed.

B. Aiding and Abetting Liability

Plaintiffs's Amended Complaint also alleges that defendants aided and abetted violations of the CEA. Plaintiffs contend that they were denied the opportunity to properly evaluate investing in Sigma because Kohli and Sigma were unregistered and that by allowing Kohli to open accounts and by ignoring or relaxing margin rules, the FCM defendants aided and abetted Sigma to continue trading when underfunded. Plaintiffs contend that as Kohli was not properly registered as required under the CEA and as the defendant FCMs carried accounts, accepted orders and handled futures contracts for Sigma that "common sense dictates that the FCM defendants also aided and abetted Kohli and the Sigma entities."

Defendants contend that plaintiffs' claim of aiding and abetting CEA violations cannot be maintained against them because they are not parties that can be held liable under the statute. This Court must determine, therefore, against whom the private right of action for aiding and abetting can be maintained. Defendants assert that plaintiffs' claims for aiding and abetting commodities fraud violations must be dismissed because there is not a "buyer-seller relationship" between the FCM defendants and the plaintiffs and such relationship is a condition precedent to a private right of action under the Commodities Exchange Act. Plaintiffs contend that the statute does not require that the alleged aider and abettor be in one of the relationships set out in 7 U.S.C. § 25(a)(1)(A) - (D) with the plaintiff, but rather that only the principal must satisfy this requirement.

- This Court notes that this issue is not settled. With the exception of this Court, no Court in the Third Circuit has spoken on this issue. However, this Court held in Manley v. Stark & Stark, Civ. No. 97-524(AET) that under section 25(a)(1) a primary violator must be the "such person" who commits one of the enumerated acts in subsections (A)-(D); in other words defendants must have provided plaintiffs with trading advice for a fee, made any contract of sale of any commodity for future delivery or accepted the deposit of money, securities or property in connection with any order to make such contract; or sold to or accepted the order for the purchase or sale of or interest or participation in a commodity pool. In so finding, this Court followed the majority of Courts to have spoken on this issue and found that in order to establish aider and abettor liability, plaintiffs must be in one of the four above stated relationships with the defendants. See also Damato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 878 F.Supp. 1156, 1161 (N.D. Ill. 1995) (holding that the only persons subject to a private right of action under § 25(a) of the CEA are those who sold or took orders for interests in the commodity pool); Davis v. Coopers & Lybrand, 787 F.Supp. 787 (N.D. Ill, 1992) (same); In re Lakes States Commodities, Inc., 936 F.Supp. 1461, 1467 (N.D. Ill. 1996) (Stating, "Congress could not have more clearly pronounced its intention to create only one vehicle for private causes of action . . . and given recent Supreme Court teachings on statutory construction, we are loathe to imply a private right of action into § 13(a)."); Grossman v. Citrus Assoc. of N.Y. Cotton Exchange, 706 F.Supp. 221, 2312 (S.D.N.Y. 1989); Kolbeck v. LIT America, Inc., 923 F.Supp. 557, 566 (S.D.N.Y. 1996).

Plaintiffs argue that this Court should reverse its earlier decision, and ignore the above stated cases and find that a buyer-seller relationship is not required in order to state a cause of action for aiding and abetting under the Commodities Exchange Act. In support of this position, plaintiffs have provided this Court with an amicus curiae brief submitted by the CFTC to the Seventh Circuit Court of Appeals in the D'Amato case advocating a broader reading of possible aiding and abetting liability. Although noting the argument of the CFTC to the contrary, this Court finds that the statute on its face appears to preclude private rights of action against either a principal or an aider and abettor absent the existence of one of the four relationships described in § 25(a)(1). Further, it would appear from reading § 25(a)(2) that a private right of action is not available outside the confines of § 25(a)(1). Therefore, this Court will follow the reasoning of the majority of courts to speak on this issue and preclude a private right of action absent one of the relationships listed in § 25. As this Court has found above that no such relationship has been adequately alleged in the instant case, Count I must be dismissed.

5. Count Two: Breach of Contract

In the second count of their Amended Complaint, plaintiffs allege a violation of New Jersey common law regarding contracts against defendants FCMs, FCM EMPLOYEES and the NFA. More specifically, plaintiffs allege that they were third party beneficiaries of the agreements between the NFA and its members. ¶ 137. In particular, plaintiffs rely upon NFA Bylaw 1101 and NFA Compliance Rule 2-8(e) as the sources of their purported contractual rights. ¶ 143

NFA Bylaw 1101 provides that:

> No Member may carry on an account, accept an order or handle a transaction in commodities futures contracts for or on behalf of any non-Member of the NFA, or suspended Member, that is required to be registered with the Commission [CFTC] as an FCM, IB [Introducing Broker], CPO, CTA or LTM [Leverage Transaction Merchant], and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or other person.

The interpretive notice regarding Bylaw 1101 states in part that, "the Rule, by its terms imposes strict liability on any Member conducting customer business with a non-Member that is required to be registered. The Rule does not require proof that the Member firm was at fault or failed to exercise due diligence -- simply that it transacted customer business with a non-Member that is required to be registered." NFA Compliance Rule 2-8(e) provides the "[n]o member FCM shall accept a customer account and no Member FCM or IB shall introduce a customer account over which a third party, not an associate of such FCM or IB, is to exercise discretion" without first obtaining an authorization from the customer and an acknowledgment from that customer that they received certain disclosure documents.

Based on the alleged violation of this Bylaw and Compliance Rule, plaintiffs contend they are entitled to bring a claim for breach of contract as third party beneficiaries of

the contract between the defendant NFA and its members, the defendant FCMs. Plaintiffs claim that members of the general public are third party beneficiaries of the NFA Manual and are entitled to recover from the NFA under a breach of contract theory every time that a scheme to defraud involving the futures market is perpetrated. Defendants contend that this claim must fail as the general public are not third party beneficiaries of the NFA's contract with its members. The defendants further contend that general statements of the NFA's desire to benefit the general investing public cannot support a third party beneficiary claim for breach of contract as there is no evidence that the NFA and its members intended to bestow contractual rights on the general public under the NFA Manual or Bylaws.

In New Jersey, a third party beneficiary may sue upon a contract made for his or her benefit without being privy to the contract. Rieder Communities, Inc., v. North Brunswick Tp., 227 N.J. Super. 214, 222 (App. Div. 1988), cert. denied, 113 N.J. 638 (1988); see also N.J.S.A. 2A:15-2 (providing that a person for whose benefit a contract is made may sue on the contract in any court). The standard for determining third-party beneficiary status is "whether the contracting parties intended that a third party should receive a benefit which might be enforced in the courts . . ." Rieder, 227 N.J. Super. at 222 (quoting Brooklawn v. Brooklawn Housing Corp., 124 N.J.L. 73, 77 (E & A, 1940). Absent such a conclusion derived from the contract or surrounding circumstances, "a third party has no cause of action despite the fact that it may derive an incidental benefit from the contract's performance." Rieder, 227 N.J. Super, at 222 (citing Gold Mills, Inc. v. Orbit Processing Corp., 121 N.J. Super. 370, 373 (Law Div. 1972).

When considering the intent of the contracting parties, however, "it is not necessary that an intended beneficiary be identified when the contract containing the promise is made," nor is it necessary for the promises's obligation to the intended beneficiary to be in existence at the formation of the contract. Werrmann v. Aratusa, LTD., 266 N.J. Super. 471, 476-77 (App. Div. 1993). The "real test" in determining if a party is a third-party beneficiary to a contract is "whether the contracting parties intended that a third party should receive a benefit which might be enforced in the courts." Brooklawn v. Brooklawn Housing Corp., 124 N.J.L. 73, 11 A.2d 83 (1940); accord Air Master Sales Co. v. Northbride Park Co-op, Inc., 748 F. Supp. 1110, 1117 (D.N.J. 1990). A third-party, who is not an intended beneficiary, but incidentally benefits from a contract, has no contractual right to enforce the contract. See Grant v. Coca-Cola Bottling Co., 780 F. Supp. 246, 249 (D.N.J. 1991).

There is simply no indication in the instant case that plaintiffs were the intended beneficiaries of the contractual relationship between the NFA and its FCM members. Plaintiffs find evidence of an intent to benefit them in the broad proclamations made concerning the association's desire to protect the investing public and the following language from Interpretive Notice regarding Bylaw 1101, "the suggested procedures should help foster . . . greater protection to the investing public." This language does not affirmatively indicate any desire to permit non-parties to enforce its terms. The Bylaw and Compliance Rule relied upon by the plaintiffs in this case do not indicate that non-parties have the right to seek private judicial remedies to enforce the agreement.

Further, third party enforcement of the rules of a self-regulator, organization has been considered and rejected by a number of other Courts. See Lake States Commodities, 936 F.Supp. 1461 (N.D. Ill. 1996) (NFA Bylaw 1101 and Compliance Rule 2-8(e), relied upon by plaintiffs in this case do not indicate that non-parties have the right to seek private judicial remedies to enforce the agreement. Without such language, the plaintiffs cannot claim third-party beneficiary status); Bloch v. Prudential-Bache Sec., 707 F.Supp. 189, 195-96 (W.D. Pa. 1989) (concluding that allowing third-party beneficiary claims under NYSE and NASD rules seems incongruous with the large body of case law holding that no private cause of action exists for violations of the rules of self-regulatory organizations); Pittsburgh Terminal Corp. v. Baltimore & Ohio R. Co., 509 F.Supp. 1002 (W.D. Pa. 1981) rev'd on other grounds, 680 F.2d 933 (3d Cir.) cert. denied 459 U.S. 1056 (1982) (Court refused to allow a third party claim for violation of NYSE rules);

Plaintiffs have cited several New Jersey cases in which third party beneficiary status has been found in the context of insurance. See Eschle v. Eastern Freight Ways. Inc., 128 N.J. Super, 299, 306 (1974); Wermann v. Aratus, Ltd., 266 N.J. Super. 471 (App. Div. 1993). However, these cases are clearly distinguishable and do not support a finding by this Court that a third party beneficiary relationship, upon which a private right of action can be based was created by the contractual relationship between the NFA and the FCM defendants. As there is no indication that the NFA and its members intended to bestow contractual rights on the public under the NFA Manuals or Bylaws, plaintiffs' third party beneficiary claim must be dismissed. Therefore, Count II of

plaintiffs' Amended Complaint alleging breach of contract will be dismissed.

6. Count Three: Bad Faith Failure to Enforce NFA Rules

Count Three is asserted by plaintiffs pursuant to the CEA, 7 U.S.C. § 25(b) and the regulations established pursuant to the CFTC against defendant NFA. Plaintiff asserts that the NFA acted in bad faith in failing to enforce its own Bylaws and Rules as set forth in the NFA Manual, pursuant to 7 U.S.C. § 21(b)(8).

Section 21(b)(8) states that "the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violations of its rules." The CEA states at § 25(b)(2) that a registered futures association that fails to enforce any bylaw or rule that is required under section 21 of this title, or in enforcing any such bylaw or rule violates this chapter or any Commission rule, regulation or order shall be liable for actual damages sustained by a person that engaged in any transaction specified in subsection (a) of this section to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce or enforcement of such bylaw or rule. In order to be liable under these provisions, a contract market or clearing market must fail to enforce a bylaw, rule or regulation that is required to be enforced by Section 17 of the CEA.

Defendants allege that the NFA prohibition against doing business with non-members that is contained in Bylaw 1101 is not a bylaw required by Section 17 of the CEA and thus no private cause of action can be enforced for its non-enforcement. The NFA adopted Bylaw 1101, which indirectly compels membership in the NFA for all Commission registered FCMs pursuant to Section 17(m) of the CEA. Section 17(m) of the CEA provides that "the Commission may approve rules of futures associations that, directly or indirectly, require persons eligible for membership in such associations to become members of at least one such association . . ." Defendants contend, and this Court agrees, that the plain meaning of the word "may" in Section 17(m) permits the NFA to adopt rules such as Bylaw 1101, but does not require the NFA to do so as a condition.

Similarly, Rule 2-8(e) is not one of the Rules which the CFTC required under § 17 of the CEA as a condition to its authorization to the NFA to be a RFA. In fact, the CFTC approved the NFA's application for membership before Rule 2-8(e) was in existence, thus indicating that any requirements of the CEA were fully satisfied by the existing Rules 2-8(a) through 2-8(d). The NFA was in existence for four years before Rule 2-8(e) was added. This Court cannot, therefore, find that Rule 2-8(e) was a rule required by the CFTC, but rather it is a discretionary Rule passed by the NFA only to assist its members in their own internal compliance with Bylaw 1101 and as such, it cannot provide the basis for a private right of action against the NFA.

Courts have consistently held that Section 22 does not provide any private remedy for purported violations of CFTC Regulations and NFA Bylaws and rules. Courts have declined

to imply a private cause of action into NFA Bylaw 1101 and its Interpretive Notice. Lake States Commodities, Inc., 936 F.Supp. 1461, 1469 (N.D. Ill. 1996) (declining to imply a cause of action into [NFA] Bylaw 1101 and its Interpretive Notice and holding that plaintiffs who had invested money with unregistered commodity pool operator failed to state a claim under the CEA against futures commission merchant). Courts have similarly declined to imply a private cause of action into other NFA rules. See In re Indemnified Capital Invs., S.A. v. R.J. O'Brien & Associates, Inc., 12 F.3d 1406, 1412 (7th Cir. 1993). See also Davis v. Coopers and Lybrand, 787 F.Supp. 787 (N.D. Ill. 1992) (The exclusive private remedy under CEA does not include a cause of action for violations of CFTC regulations.); In re Soybean Futures Litigation, 892 F.Supp. 1025 (N.D. Ill. 1995) (Neither Section 4a nor Section 22 authorize private enforcement of CFTC regulations nor have courts been willing to recognize such a claim); Khalid Bin Alwaleed Found. v. E.F. Hutton & Co., 709 F.Supp. 815, 820 (N.D. Ill. 1989) (finding that Congress did not intend that the rules promulgated by the CFTC should give rise to a private cause of action); Unity House, Inc. v. First Commercial Financial Group, 1997 WL 701345 at * 4 (N.D. Ill. Nov. 5, 1997) (the CFTC and the NFA rules do not provide causes of action); Indemnified Capital Investments. S.A. v. R.J. O'Brien & Assoc., 12 F.3d 1406, 1412 (7th Cir. 1993) (dismissing investment company's action against FCM because no independent private right of action existed under NFA Compliance Rule 2-4 concerning just and equitable principles of trade); Birotte v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 468 F.Supp. 1172, 1180 (D.N.J. 1979) (holding that there is no implied federal right of action for alleged violations of the New York Stock Exchange and Chicago Board Options Exchange Rules).

7. Count Four: New Jersey Uniform Securities Law

Count Four is asserted pursuant to the New Jersey Uniform Securities Law, N.J.S.A. 49:3-47 et seq., against defendants FCMs and FCM EMPLOYEES as primary offenders, or in the alternative, as secondary offenders.

N.J.S.A. 49:3-71 (a)(2) and (b) provide:

(a) Any person who

(2) Offers or sells a security in violation of subsection (a) or (c) of [N.J.S.A.] or by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), is liable to the person buying the security from him . . .

(b) Every person who directly or indirectly controls a seller is liable under paragraph (a) . . . and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the nonseller who is so liable sustains the burden of proof that he did not know, and in the exercise of reasonable care could not

> have known, of the existence of the facts by reason of which the liability is alleged to exist.

The text of Section 49:3-71, therefore, requires that the offender must offer or sell securities to the aggrieved purchaser of those securities, or "materially aid" in the sale of those securities.

To be a "seller" of securities the defendant must pass title to the security to the plaintiff, or defendant must solicit plaintiff to purchase the security. Pinter v. Dahl, 486 U.S. 622 (1988). Mere allegations that the defendant's participation in the transaction was a substantial factor in causing the sale to occur is insufficient to establish that the defendant is a statutory seller. Zendell v. Newport Oil Corp., 226 N.J. Super. 431, 440-441 (App. Div. 1988). To establish liability on the part of a broker-dealer for "materially aid[ing] in the sale of a security, the plaintiff must demonstrate that the broker-dealer's involvement in the sale is "considerable, significant or substantial." Schor v. Hope, 1992 U.S. Dist. LEXIS 1003, 15-17 (E.D. Pa. 1992).

Defendants contend that the FCM defendants are not alleged to have "offered or sold" any securities so as to incur liability under the statute and further that they did not "materially aid in the sale" of securities so as to face liability under the statute. Defendants further contend that plaintiffs have also failed to allege that the FCM defendants played a "substantial role in persuading or seducing the purchasers into buying securities." Craighead v. E. F. Hutton & Co., 899 F.2d 485, 493 (6th Cir. 1990).

This Court finds no allegation which supports a finding that defendants either passed title to the securities in question or were involved in the sale to the extent required by law. There are no allegations that defendants in this case had any contact with plaintiffs, so as to solicit or persuade plaintiffs to purchase securities.

Plaintiffs also contend that defendants aided and abetted in a violation of the statute. The Restatement of Torts provides that a person is liable for harm resulting to a third person from the conduct of another when he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the others so to conduct himself. Restatement (Second) of Torts § 876(b). Courts have recognized that the Restatement provision sets forth the standard for civil aiding and abetting, See Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 162 (3d Cir. 1973) cert. denied 416 U.S. 960 (1974).

In this case, this Court cannot find that plaintiffs' allegations support a claim that defendants aided and abetted a violation of the statute. Even accepting all of plaintiffs' allegations as true and reading all inferences in favor of plaintiffs, plaintiffs have not alleged sufficient facts to indicate that defendants gave Kohli substantial and knowing assistance in the sale of securities. Therefore, Count IV fails to state a claim for either a direct violation of or aiding and abetting a violation of the Uniform Securities Act.

8. Count Seven: Breach of Fiduciary Duties

Count Seven is brought pursuant to common law and is asserted against defendant FCMs, FCM EMPLOYEES,

Delbridge, Stone and the NFA. Plaintiffs assert that the named defendants knew or should have known in the exercise of reasonable care that the money invested by Kohli and Chandran was the property of the plaintiff class members and that defendants, as fiduciaries with respect to the plaintiff class members were required to exercise reasonable and prudent discretion in connection with such transactions in the best interest of plaintiff. ¶ 182. Plaintiffs contend that the NFA as a non-profit organization charged with self-regulation, had a duty to protect the public interest, and thus had a duty to protect the plaintiffs in this case. Plaintiffs further contend that the NFA breached that fiduciary duty to the investing public when it failed to uncover the fraud at issue in the instant case. Defendants argue that in the absence of any allegation of a transactional relationship or other dealings between plaintiffs and defendants, defendants clearly owe no fiduciary duty to plaintiffs.

Under New Jersey Law, a confidential or fiduciary relationship encompasses all relationships "whether legal, natural, or conventional in their origin, in which confidence is naturally inspired, or in fact, reasonably exists." Pascale v. Pascale, 113 N.J. 20, 33-34 (1988). A fiduciary, therefore is a person with a duty to act primarily for the benefit of another. For a breach of fiduciary duty claim to succeed, plaintiff must show that either the particular relationship presumes fiduciary duties, or that the particular facts indicate that within this particular relationship, fiduciary duties have arisen. Hensler v. Busey Bark, 231 Ill. App. 3d 920, 927 (4th Dist. 1992).

Plaintiffs claim that the NFA manual and the CEA make the NFA "fiduciaries or quasi-fiduciaries" to the

plaintiffs in their dealings with Kohli, Chandran and Sigma which required the NFA to exercise reasonable and prudent discretion in connection with such transactions in the best interest of plaintiffs, and that defendants breached such duty. This Court disagrees. Plaintiffs contend that the NFA breached a fiduciary duty to the investing public when it failed to uncover the fraud at issue here. Plaintiffs have provided no support for their contention that a fiduciary duty is owed to them by with the NFA or the FCM defendants. Further, the lack of relationship between the plaintiffs and defendants forecloses the possibility that a fiduciary relationship existed between them. See Melrose v. Shearson/American Express, 1988 WL 9042, *12-13 (N.D. Ill. 1998) (lack of interaction bars a fiduciary duty claim -- a fiduciary duty is created by interaction between two parties, plaintiff cannot unilaterally impose a fiduciary duty upon the defendant). Considering these factors, this Court will follow a number of other Courts which have held that neither federal commodities laws, nor the NFA's Rules or Bylaws give rise to a relationship of trust and dominance so as to establish a fiduciary relationship. See Indemnified Capital Invs. S.A. v. R.J. O'Brien & Assocs., 12 F.3d 1406, 1411-12 (7th Cir. 1993) (no fiduciary duty created by NFA Compliance Rule 2-4); Baird v. Franklin, 141 F.2d 238, 239 (2d Cir. 1944) (no fiduciary duty arising from the stock exchange's requirement to investigate member wrongdoing); Spicer v. Chicago Board of Trade, 1990 WL 172712 at *15 (N.D. Ill. October 30, 1990) aff'd 977 F.2d 255 (7th Cir. 1992) (fiduciary duties are not lightly inferred . . . we conclude that the CBOE and OCC are not in a fiduciary relationship with investors who buy or sell options through their facilities); Arneil v. Ramsey, 414 F.Supp. 334, 343 (S.D.N.Y. 1976) (no fiduciary relationship between exchange and public customers of member firms); Piemonte

v. Chicago Board of Options Exchange, Inc., 405 F.Supp. 711, 718 n.4 (S.D.N.Y. 1975) (same); Steinberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 1974 WL 411 at *1 (S.D.N.Y. 1974) (New York Stock Exchange has no fiduciary duty to investors arising from its statutory duty to supervise brokers). Therefore, this Court finds that even accepting plaintiffs' allegations as true and reading all inferences in favor of plaintiffs, they have failed to state a claim upon which relief can be granted and their claim for breach of fiduciary duty is dismissed.

This Court notes that defendant NFA has raised the issue of preemption with regard to the common law claims made against it in plaintiffs' complaint. The NFA states that allowing a plaintiff to bring a state law claim against a self regulatory organization which is an integral part of the CEA's self-regulatory) scheme would frustrate Congress' intent to bring the markets under a uniform set of regulations. However, as all of the plaintiffs' claims which named the NFA as a defendant have failed to state a claim upon which relief can be granted and thus cannot be maintained, this Court need not address defendant NFA's contention that the maintenance of claims against it would be inappropriate.

9. Count Eight: Negligence

In Count Eight, plaintiffs assert a claim pursuant to common law against defendants FCMs and FCM EMPLOYEES for failure to exercise reasonable care and acting in a negligent manner. ¶ 189-190. Plaintiff contends that the FCMs and FCM EMPLOYEEs were negligent in failing to conduct a more thorough investigation of the source of funds invested by Kohli and Chandran; by assisting and

encouraging Kohli and Chandran in soliciting investors for commodity futures trades; by failing to adequately train their respective agents with regard to the laws and regulations governing commodity futures trading and the NFA Ethics Rules and in failing to diligently supervise the activities at their respective offices and solicitation of accounts traded through their respective offices. ¶ 190. Defendants contend that as they owed no duty to the plaintiffs, they cannot be held liable under a negligence theory.

New Jersey law applies to plaintiffs' claim of negligence. New Jersey law requires that in order to state a cause of action for negligence, a plaintiff must allege and prove a set of facts showing he has a substantive right entitling him to maintain a cause of action and that there is a violation of that right by defendant which causes injury or damage. Ryans v. Lowell, 197 N.J. Super. 266, 274 (App. Div. 1984). In order to state a claim for negligence, a plaintiff must first establish that a duty is owed to the plaintiff by a defendant. Strachan v. JFK Memorial Hospital, 109 N.J. 523, 529 (1988). The question of whether a duty exists is a matter of law properly decided by the Court, and is largely a question of fairness and policy. Wang v. Allstate Co., 125 N.J. 2, 15 (1991). If this Court finds no duty exists, there can be no action for negligence. Ryan, 197 N.J. Super. at 275.

A duty of care exists when an actor creates an unreasonable risk of foreseeable harm or when such a duty is judicially imposed by policy considerations. Griesenback v. Kutter v. Walker, 199 N.J. Super. 132, 136 (App. Div. 1985) cert. denied 101 N.J. 264 (1985). In order for a Court to find the existence of a duty, this Court must make a "value

judgment, based on an analysis of public policy, that the actor owed the injured party a duty of reasonable care." Kelly v. Gwinnell, 96 N.J. 538, 544 (1984). This value judgment requires a "weighing of the relationship of the parties, the nature of the risk, and the public interest in the proposed solution." Goldberg v. Housing Auth. of Newark, 38 N.J. 578, 583 (1962); Carvalho v. Toll Brothers and Developers, 143 N.J. 565 (1996).

In the instant case, there was no relationship between plaintiffs and defendants. Although it is alleged that defendants knew or should have known that Kohli was trading for third parties, there are no allegations that defendants had any contact with plaintiffs to solicit business or provide advice. Considering the absolute absence of a relationship between plaintiff and defendants, this Court cannot find that defendants' actions created an unreasonable risk of harm to plaintiffs or that the injury to plaintiffs was foreseeable in the instant case. See Riggs v. Schappell, 939 F.Supp. 321, 332 (D.N.J. 1996) (Finding that a clearing broker does not owe the customer of an introducing broker a "broad fiduciary duty" sufficient to support a negligence action under New Jersey law); Kolbeck v. LIT America, Inc, 923 F.Supp. 557 (S.D.N.Y. 1996) (Securities brokers do not owe a general duty of care or disclosure to the public simply because they are market professionals. A duty of care arises only when the broker does business with the plaintiff and then the duty of the broker is to attend to the plaintiff's business with care). Therefore, Count VIII of plaintiffs' Amended Complaint will be dismissed.

10. Count Nine: RICO, 18 U.S.C. § 1962(c) and § 1962(d)

In Count Nine, plaintiffs allege that the defendants violated the provisions of the Racketeer Influenced and Corrupt Organizations Act. 18 U.S.C. §§ 1961 et seq. Specifically, plaintiffs allege a violation of Section 1962(c) which provides in relevant part:

> It shall be unlawful for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly in the conduct of such enterprise's affairs through a pattern or practice of racketeering activity or collection of an unlawful debt.

18 U.S.C. § 1962(c). Section 1962(c) requires the plaintiff to plead the following: 1) the existence of an enterprise whose activities affect interstate commerce; 2) that defendants participated in the conduct of the affairs of the enterprise; and 3) that the participation took the form, at least in part, of racketeering activities. Plaintiffs must also plead that they were injured in their business or property by reason of a violation of § 1962(c).

Liability under § 1962(c) only attaches to persons who participate in the operation or management of the RICO enterprise. Reves v. Ernst & Young, 113 S.Ct. 1163, 1172-74 (1993). This means that § 1962(c) may not be imposed on one who merely "carries on" or "participates" in an enterprise, but rather, in order to be liable, "one must have some part in directing those affairs." Id. at 1168-70. The mere rendering of professional services does not constitute participation in the direction of the corporation to whom those services were provided. University of Maryland v. Peat, Marwick, Main, 996 F.2d 1534, 1539 (3d Cir. 1993).

"Simply because one provides goods or services that ultimately benefit the enterprise does not mean that one becomes liable under RICO as a result. There must be a nexus between the person and the conduct in the affairs of an enterprise. The operation or management test goes to that nexus." University of Maryland, 996 F.2d at 1539. "Outsiders" may be liable under § 1962(c) if they are "associated with" an enterprise and participate in the conduct of its affairs to the point that they in some way direct the enterprise. Reves, 507 U.S. at 185. Under this test, not even action involving some degree of decisionmaking constitutes participation in the affairs of an enterprise. University of Maryland, 996 F.2d at 1538.

Many courts faced with post-Reves § 1962(c) claims against outside professionals have agreed that providing important services to a racketeering enterprise is not the same as directing the affairs of the enterprise. See e.g. Azrielli v. Cohen Law Offices, 21 F.3d 512, 521-22 (2d Cir. 1994) (provision of legal services related to fraudulent real estate transaction was not management of the RICO enterprise conducting the fraudulent transaction); University of Maryland at Baltimore at Maryland v. Peat, Marwick, Main & Co., 996 F.2d 1534, 1539 (3d Cir. 1993) ("Simply because one provides goods or services that ultimately benefit the enterprise does not mean that one becomes liable under RICO as a result); Fidelity Federal Sav. & Loan Ass'n v. Felicetti, 830 F.Supp. 257, 260 (E.D. Pa. 1993) (even if appraiser's reports are "keystone" of enterprise's perpetration of fraud, appraiser cannot be liable under section 1962(c)); United States v. Oreto, 37 F.3d 739, 750 (1st Cir. 1994) (accountants in Reves were not liable because "while they were undeniably involved in the enterprise's decisions, they neither made those

decisions nor carried them out; in other words, the accountants were outside the chain of command), cert. denied 115 S.Ct. 1161 (1995); Baumer v. Pachl, 8 F.3d 1341, 1344 (9th Cir. 1993) (providing legal services to an enterprise did not satisfy "operation or management" test); Stone v. Kirk, 8 F.3d 1079, 1092 (6th Cir. 1993) (sales representative did not participate in "operation or management" of the enterprise).

Plaintiffs contend that defendants directly participated in the RICO enterprise by carrying the accounts of the Sigma Entities and by transacting the business of the Sigma entities through the clearing of commodity futures contracts and options transactions. Plaintiffs contend that within the customer account agreements between the Sigma entities and the defendant FCMs there is a clear and undisputable right to exercise control over the Sigma entities because the defendant FCMs had the right to limit or cease the trading of Sigma if the Sigma accounts failed to meet certain financial conditions or violated reasonable risk parameters. According to defendants, this inactivity is insufficient to qualify as "taking some part in directing the enterprise's affairs."

This Court cannot find that plaintiffs have adequately alleged that defendants participated in the operation or management of the Sigma entities. While plaintiffs have alleged that defendants' inaction allowed the Sigma entities to continue trading, there are no allegations that any of the defendants had decisionmaking authority at Sigma, or along with Kohli and Chandran was directing the fraudulent enterprise. Therefore, even reading plaintiffs' allegations as true, this Court finds that plaintiffs' have failed to state a claim upon which relief can be granted, and their RICO claim must be dismissed.

Plaintiffs have also alleged that defendants conspired to violate RICO in contravention of § 1962(d). Conspiracy to violate any other provision of § 1962 is a separate RICO violation. To plead conspiracy adequately, a plaintiff must set forth allegations that address the period of the conspiracy, the object of the conspiracy, and the certain actions of the alleged conspirators taken to achieve that purpose. Kalmanovitz v. G. Heileman Brewing Co., 595 F.Supp. 1385, 1400-1401 (D.Del. 1984) aff'd 769 F.2d 152 (3d Cir. 1985). A defendant must 'knowingly agree, to participate in the enterprise through a pattern of racketeering. United States v. Riccobene, 709 F.2d 214, 220-21 (3d Cir.) cert. denied 464 U.S. 849 (1983). Additional elements include agreement to commit predicate acts and knowledge that the acts were part of a pattern of racketeering activity. Shearin v. E.F. Hutton Group, Inc., 885 F.2d 1162, 1167 (3d Cir. 1989); Odesser v. Continental Bank, 676 F.Supp. 1305, 1312-1313 (E.D. Pa. 1987).

This Court notes that a § 1962(d) claim can exist in the absence of a viable claim under §1962(c). See United States v. Antar, 53 F.3d 568 (3d Cir. 1995); see e.g. United States v. Viola, 35 F. 3d 37, 43 (2d Cir. 1994) (a "RICO conspiracy charge is proven if the defendant embraced the objective of the alleged conspiracy and agreed to commit two predicate acts in furtherance thereof, irrespective of the fact the defendant did not participate in the operation or management of the enterprise). However, liability is limited to those who conspire to operate or manage an enterprise, and does not extend to those who conspire with someone who is operating or managing the enterprise. See Antar, 53 F.3d 568, 581 (3d Cir. 1995). In the instant case, plaintiffs have not alleged that defendants conspired to operate or manage the enterprise, but

merely that they conspired with the individuals who did so. Therefore, plaintiffs have failed to state a claim under § 1962(d) and this claim will be dismissed.

11. Count Ten: Fraud and Civil Conspiracy

In Count Ten, brought pursuant to New Jersey common law against defendants FCMs and FCM EMPLOYEES, plaintiffs assert claims of fraud and civil conspiracy. Plaintiffs contend that defendant FCMs and FCM EMPLOYEES breached their duties by aiding and abetting Kohli, Chandran and the Sigma Entities in their frauds and conspiring with them to commit these frauds or acting in concert with them in these frauds by concealing the true nature of their activities from plaintiffs. ¶ 212. Further, plaintiffs contend that defendant FCMs defrauded plaintiffs by intentionally creating the false public perception that the unregistered pool was large, profitable and legitimate and by failing to disclose material facts to plaintiffs. ¶ 213. With regard to their claim of conspiracy, plaintiffs contend that defendant FCMs conspired in combination with Kohli, Chandran and the Sigma Entities to commit criminal or unlawful acts including but not limited to conspiring to obtain funds from the plaintiff class members by misrepresentation or fraud and conspiracy to cover up the true nature of Kohli and Chandran's "Ponzi" scheme. ¶ 216.

Under New Jersey law, the elements of civil fraud are: 1) the making of a misrepresentation of material fact; 2) which is made with the knowledge of its falsity; 3) that plaintiffs rely upon to their detriment. Jewish Center of Sussex County v. Whale, 86 N.J. 619, 624-25 (1981). There can be no liability for misrepresentations based on failure to

disclose unless a duty to disclose exists. See Lightning Lube, Inc. v. Witco Corp., 4 F.3d 1153, 1185, 1187 (3d Cir. 1993). As this Court finds that there was no duty imposed upon defendants with regard to plaintiffs, this Court cannot find that the failure of defendants to disclose information it is alleged to have knowledge of constitutes fraud. Therefore, plaintiffs claim of fraud must be dismissed.

A civil conspiracy is "a combination of two or more persons acting in concert to commit an unlawful act or to commit a fanciful act by unlawful means, the principal element of which is an agreement between the parties to inflict a wrong or injury upon another, and an overt act that results in damage." Morgan v. Union County Board of Chosen Freeholders, 268 N.J. Super. 337, 364 (App. Div. 1993). "The gist of the claim is not the unlawful agreement, but the underlying wrong which, absent the conspiracy, would give a right of action." Id. In order to show civil conspiracy, an act must be committed by at least one of the co-conspirators towards the fulfillment of the conspiracy, and this action must cause some injury to the plaintiff. A conspiracy need not be proven directly, but rather can be inferred from the circumstances. A co-conspirator is liable for all of the acts of his fellow conspirator made in furtherance of the conspiracy. Morgan v. Union County Board of Chosen Freeholders, 268 N.J. Super. 337, 364-366 (App. Div. 1993). Proof of a conspiracy makes the conspirators jointly liable for the wrong and the resulting damages. Board of Education of the City of Asbury Park v. Hoek, 38 N.J. 213 (1962). As direct evidence of an unlawful agreement is rare, the Supreme Court has stated that "the question of whether an agreement exists should not be taken from the jury in a civil conspiracy case so long as there is a possibility that the jury can infer from the

circumstances [the alleged conspirators] had a meeting of the minds and thus reached an understanding to achieve the conspiracy's objectives." Addickes v. S.H. Kress, 398 U.S. 144, 158 (1970).

In the instant case Plaintiffs have failed to allege facts from which this Court could infer a meeting of the minds or an agreement to carry out the fraudulent scheme. Therefore, plaintiffs' claim for civil conspiracy must be dismissed.

12. Count Eleven: New Jersey Consumer Fraud Act, N.J.S.A. 56:8-1, et seq.

In Count Eleven, plaintiffs assert a claim under the New Jersey Consumer Fraud Act against defendants FCMs and FCM EMPLOYEES. Plaintiffs contend that the named defendants have violated the New Jersey Consumer Fraud Act by allowing Kohli, Chandran and the Sigma Entities to trade commodities, futures contracts, commodity options and contracts for sale of commodities for future delivery, on behalf of non-Members of the NFA that are required to be registered with the CFTC, thereby causing the acts of Kohli, Chandran and the Sigma Entities to appear to be legal. Plaintiffs assert that defendants' acts constitute unfair or deceptive trade practices and are in violation of the New Jersey Consumer Fraud Act in that defendants knowingly concealed and suppressed the material fact that Kohli, Chandran and the Sigma Entities were not registered with the CFTC as an AP, a CPO or a CTA nor a member of the NFA, in connection With the sale of merchandise and that such actions are in violation of Federal and state statutes enacted in the public interest and therefore constitute a violation of the New Jersey Consumer Fraud Act. ¶221.

The New Jersey Consumer Fraud Act provides that:

> . . . [T]he knowing, concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression or omission in connection with the sale or advertisement of any merchandise or real estate . . . is declared to be an unlawful practice.

N.J.S.A. § 56:8-2 (1996). Merchandise is broadly defined as "any objects, wares, goods, commodities, services, or anything offered, directly or indirectly to the public for sale." N.J. Stat. Ann, tit. 56 § 8-1(c). The New Jersey Consumer Fraud Act is, as its name implies, designed to protect consumers from deceptive sales or advertising practices. Its broad language evidences "legislative concern over sharp practices and dealings in the marketing of merchandise and real estate whereby the consumer could be victimized by being lured into a purchase through fraudulent, deceptive or other similar kind of selling or advertising practice." Daaleman v. Elizabethtown Gas Co., 77 N.J. 267, 271 (1978).

The New Jersey Consumer Fraud Act does not apply to the sale of "securities". Bramblewood Investors, Ltd. v. C & G Assoc., 262 N.J. Super, 96, 109 n.6 (Law Div. 1992); In re Catanella, 583 F.Supp. 1388, 1441-44 (E.D. Pa. 1984). Part of the reason for such exclusion is the differentiation between professional or semi-professional services and traditional "consumer" services. In re Catanalla, 583 F.Supp. 1388 (1984) ("there is a distinction . . . between the policies underlying the protection of consumers in general and the

protection of investors in particular. . . . Securities fraud is qualitatively different from the archetypal installment credit sale scam where the uneducated are duped into buying inferior consumer goods at exorbitant prices. The rationale behind the Consumer Fraud Act is inapposite in the securities fraud area). Moreover, the very existence of a carefully drawn state securities law militates against the application of the Consumer Fraud Act to securities." Catanella, 583 F.Supp. at 1443.

Therefore, plaintiffs' claim based upon the Consumer Fraud Act is dismissed.

13. Rule 11 Sanctions

Defendants Saul Stone & Company LC, First Options of Chicago, Inc., Smith Barney, Inc, L.G., LC, GNI Incorporated, GNI Limited, Dean Witter Reynolds, Inc., ING (U.S.) Securities Future & Options, Inc. (d/b/a ING Futures & Options), Merrill Lynch. Pierce, Fenner & Smith, Inc., Prudential Securities, Incorporated, Rosenthal Collins Group, L.P. (f/k/a Rosenthal & Company), E.D. & F. Man International, Inc. and the National Futures Association ("NFA") have also moved for an Order sanctioning plaintiffs and their attorneys for asserting claims in violation of Fed. R. Civ. P. 11. Defendants have further moved for an award of their reasonable attorneys' fees and costs incurred as a result of the violation.

Defendants contend that despite repeated opportunities to withdraw or amend their complaint voluntarily, plaintiffs have persisted in their assertion of claims which are not well grounded in fact or supported by existing law or a good faith

modification of that law. Defendants further contend that this deliberate refusal to comply with Rule 11 warrants the application of monetary sanctions, including the payment by plaintiffs and their counsel of the reasonable fees and costs incurred by defendants. Defendants, "recognizing that the CFTC's brief on the issue represents a nonfrivolous argument for the extension, modification or reversal of the existing law under Rule 11" have withdrawn their motion for sanctions insofar as it relates to the Section 22 aiding and abetting claim brought on behalf of the plaintiffs. Defendants, however, continue to seek sanctions with regard to plaintiffs' claims of direct liability under Section 22, RICO and state claims, and claims against defendants GNI, Inc. and GNI Limited claiming that such claims are without basis in fact or law.

Pursuant to Fed. R.Civ. P. 11(b), attorneys and pro se litigants must comply with certain standards of propriety:

> (b) Representations to Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, --
>
> > (1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

> (2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
>
> (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
>
> (4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

Where an attorney, law firm or litigant has failed to comply with Rule 11(b), the Court may, after notice and a reasonable opportunity to respond, impose sanctions. However, "[r]ule 11 is intended for only exceptional circumstances." Morristown Daily Record, Inc. v. Graphic Communications, Union Local 8N, 832 F.2d 31, 32 n. 1 (3d Cir. 1987). In deciding whether sanctions are appropriate, the Court should "avoid using the wisdom of hindsight and should test the signer's conduct by inquiring what was reasonable to believe at the time the pleading, motion or other paper was submitted." Auchmuty & Greenwald v. Holtzman, 775 F.2d 535, 540 (3d Cir. 1985).

> The Rule imposes an obligation on counsel and client analogous to the railroad crossing sign, "Stop, Look and Listen." It may be rephrased, "Stop, Think, Investigate and Research" before filing papers either to initiate a suit or to conduct the litigation. These obligations conform to those practices which responsible lawyers have always employed in vigorously representing their clients while recognizing the court's duty to serve the public efficiently.

Gaiardo v. Ethyl Corp., 835 F.2d 479, 483 (3d Cir. 1987). Rule 11 should not be utilized as a fee shifting device in order to avoid requiring each party to cover its own legal expenses. Id. at 483.

The Supreme Court has concluded that "the central purpose of Rule 11 is to deter baseless filing in district court and thus, consistent with the Rules Enabling Act's grant of authority, streamline the administration and procedure of the federal courts." Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 393 (1990). The reasonable inquiry element is measured by an objective standard of reasonableness under the circumstances. See Chambers v. NASCO, Inc., 501 U.S. 32, 47 (1991). Subjective good faith on the part of the attorney is insufficient to avoid sanctions.

The court must use its own discretion to set proper sanctions under Rule 11, which may or may not include attorney's fees. Doering v. Union County Bd. of Chosen Freeholders, 857 F.2d 191, 194 (3d Cir. 1988). Sanctions are imposed under Rule 11 only to the extent necessary to deter

unfounded claims. Doering, 857 F.2d at 194. The rule is not intended as a punishment. See id at 196. The court should impose the least sanction necessary to serve as an adequate deterrence. Id. at 194.

In the instant case, plaintiffs have advanced a number of claims which this Court has not found to be viable. However, the analysis required close defining of legal theory. This Court is not persuaded that the claims were so unreasonable as to warrant Rule 11 sanctions.

CONCLUSION

For the foregoing reasons, the various motions of defendants to dismiss plaintiffs' complaint are granted, defendants' motion for Rule 11 sanction is denied and this case is closed. An appropriate order is filed herewith.

Dated: 6/30/98

APPENDIX C

UNITED STATES OF AMERICA
Before the
COMMODITY TRADING COMMISSION

[Dated 1981]

In the Matter of the	)
Application of the National Futures	)
Association	)
	)

(Excerpts From)
ORDER GRANTING REGISTRATION AND APPROVING RULES

I. Introduction

The National Futures Association ("NFA") submitted an application to the Commodity Futures Trading Commission ("Commission") for registration as a registered futures association under Section 17 of the Commodity Exchange Act ("Act"), 7 U.S.C. §21 (Supp. III 1979), on March 16, 1981. The Commission published notice of the application in the Federal Register, requested public comment and announced the Commission's intention to hold a public hearing regarding

the application.[1] In recognition of their prior interest in the Commission's consideration of issues relating to registration of futures associations, the Commission also expressly solicited the views of the Securities and Exchange Commission ("SEC"), the Antitrust Division of the Department of Justice ("Justice"), and the National Association of Securities Dealers, Inc. ("NASD").[2]

On June 4, 1981, the Commission held the public hearing announced in the Federal Register notice. Twelve individuals representing various segments of the . . .

* * *

(Page 5)

. . . be compulsory for FCMs and their agents, CPOs, and CTAs. The rules do not explicitly compel such membership, but proposed Bylaw 1101 would prohibit NFA members from carrying accounts, accepting orders, or handling accounts for

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[1] 46 FR 23101 (April 23, 1981). The Commission initially afforded the public sixty days to submit comments, but upon request of a number of interested persons, the Commission extended the comment period to July 2, 1981. 46 FR 35140 (July 7, 1981). In considering NFA's application, the Commission also took into account views expressed in comment letters received after July 2, 1981.

[2] Letters dated April 22, 1981, from Theodore W. Urban, Deputy Director, Division of Trading and Markets, to George A. Fitzsimmons, Secretary, SEC; Stanley M. Gorinson, Chief, Special Regulated Industries Section, Justice; and Gordon Macklin, President, NASD.

or on behalf of any suspended or non-member of the NFA who is not a member of another registered futures association, unless such person is exempted from the provisions of Bylaw 1101 by the NFA Appeals Committee or by resolution of the NFA Board of Directors ("Board"). In addition, Bylaw 301 would require APs of FCMs to register with the NFA as "associates." Consequently, each step in the order-handling process leading to execution by a floor broker (floor brokers will not be subject to the compulsory membership provision) would have to be effected through an NFA member or a person subject to NFA regulation.[15]

The NFA will be governed by a forty-member Board.[16] Section 2 of Article VII describes the Board's composition as follows: (a) each exchange will select a director to serve as its representative, except that every contract market having more than 20 percent of the previous calendar year's volume on all exchanges will have two directors each;[17] (b) FCMs with more than 50 branch offices will be represented by a total of six directors, while FCMs

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[15] NFA has stated that the effectiveness of this provision rests upon the presumption that all contract markets will require their FCM members to join NFA. See the NFA Registration Statement ("Registration Statement") at 8 n. 1.

[16] Article VII; Bylaw 501.

[17] The total number of contract markets that may be represented on the Board has been limited to the current eleven. Should another board of trade apply for and receive designation as a contract market, the eleven contract markets with the greatest transaction volume would be represented on the Board.

with 16-50 branch offices will be allocated four directors, as will FCMs with fewer than 16 branch offices; (c) CPOs, CTAs and commercial members ("Industry Participants") will be represented by a total of ten directors -- two directors each for CPOs and . . .

* * *

(Pages 15-17)

submitted a revised version of its draft articles of incorporation on July 20, 1977, along with a revised "Points of Agreement" setting forth the organizing committee's intent.[53] The revised draft contained a modified manner for selecting a board of directors.

Justice subsequently commented on the informal proposal, expressing its opinion that NFA's mandatory membership requirement, in particular, posed an unconstitutional delegation of agency authority and was not, as required by Section 15 of the Act, the least anticompetitive means available to the Commission to achieve the objectives of the Act.[54] The Commission then afforded NFA an

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[53] Letter from Philip F. Johnson, then Counsel for the NFA organizing committee, to Richard E. Nathan, then Acting General Counsel, dated July 20, 1977.

[54] 7 U.S.C. §19 (1976). See In the Matter of the National Futures Association, Comments of October 7, 1977, from Justice to the Commission (hereinafter cited as "1977 Justice Comments").

opportunity to respond to Justice's comments.[55] In addition, the Public Interest Economic Center, under contract with the Commission, undertook a study of the competitive aspects of the futures trading industry and expressed some reservations about the NFA proposal which are discussed below.[56] The NFA draft application thereafter was not formally submitted to the Commission and, accordingly, the Commission deferred any further consideration of the NFA's draft proposal. The concerns which Justice raised were addressed explicitly by Congress in 1978.

C. 1978 Reauthorization: Section 17(m)

During the Commission's 1978 reauthorization hearings; subcommittees of both the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry heard testimony from many witnesses expressing their opinion that a futures association should be created.[57] The Senate Subcommittee considered that:

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[55] Response of the National Futures Association to Objections to its Preliminary Proposal, January 31, 1978.

[56] See Jones, N. and Ferguson, A., Competition and Efficiency in the Commodity Futures Markets (May 1978). See also pp. 30-32 infra.

[57] See Hearings on H.R. 10285 Before the Subcommittee on Conservation and Credit of the House Committee on Agriculture, 95th Cong., 2d Sess. (pp. VIII-IX for summary of testimony) (1978) (hereinafter cited as "1978 House Hearings"); Hearings on the Reauthorization of the Commodity Futures Trading Commission Before the Subcommittee on Agricultural Research

> [t]he industry has worked to develop a regulatory organization which would apply to the CFTC for approval. . . . This title III organization is designed to regulate all FCM's taking over the responsibility in this area formerly carried out by the exchanges, whereby the exchanges will regulate all activities at the exchange level, such as floor trading practices, contract details, financial integrity of clearinghouse members, et cetera.
>
> Thus, the industry would be regulated through the exchanges concerning exchange operations, and through the title III organization concerning FCMs and their contacts with the public.[58]

During the Senate floor debate on the legislation, Senator Patrick J. Leahy stated that the proposed amendments to Title III were being offered in order:

> to speed the establishment of these associations and to allow them to assume some of the duties currently being conducted by the Commission.

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and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry, 95th Cong., 2d Sess. pt. II at 12, 13, 26, 27, 29, 30, 47, 48, 50, 51, 68, 116, 119, 121, 122, 136, 137, 186, 190 and 191 (1978) (hereinafter cited as "1978 Senate Hearings").

[58] Testimony of David T. Johnston, then Vice President, E.F. Hutton Inc., 1978 Senate Hearings at 121.

> These associations could free Commission personnel to engage in other activities.[59]

Most significantly, the committees adopted new Section 17(m), which expressly allows the Commission to approve rules of a futures association that would make membership in at least one futures association mandatory for persons eligible for membership.[60] The House Committee commented that:

> [u]se of the authority of this amendment would be completely discretionary with the Commission. The committee was persuaded that such discretion may be useful to the Commission if it should decide that such a provision is necessary for an effective self-regulation program and is otherwise in the interest of the objectives of section 17.[61]

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[59] See 124 Cong. Rec. S10535 (daily ed. July 12, 1978). See also remarks of Rep. Foley, 124 Cong. Rec. H7206 (July 24, 1978); and S. Rep. No. 850, accompanying S.2391, 95th Cong., 2d Sess. 30 (1978).

[60] The Senate Committee's mandatory membership amendment to Section 17 would have granted the Commission the authority to approve mandatory membership rules of either a Title III association or a contract market for persons eligible for membership. See S. Rep. No. 850, 95th Cong., 2d Sess. 31 (1978).

[61] H.R. Rep. No. 1181, 95th Cong., 2d Sess. 20 (1978).

The Conference Committee of the Senate and House agreed to adopt the House amendment, thereby explicitly permitting the Commission to approve mandatory membership rules of any futures association. The conferees also adopted provisions that increased the limit on the amount in controversy in futures association customer arbitration proceedings to $15,000 and authorized the Commission to delegate to a registered association certain aspects of the Commission's registration functions for APs.[62]

D. Adoption of Part 170; The NFA Application

In furtherance of its statutory mandate under Section 17 of the Act, the Commission adopted, effective April 10, 1979, regulations governing applications for registration submitted under Title III and specifying standards with which such applications must comply.[63] The Commission's regulations expanded upon the . . .

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(Pages 19-21)

. . . implement. Rather, in seeking registration as currently structured and formulated, the NFA would commence operations with responsibility for certain core self-regulatory

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[62] See 124 Cong. Rec. H10685, H10687, H10691 (September 25, 1978).

[63] The Commission adopted Part 170 of its regulations (17 CFR Part 170 (1981)). See 44 FR 20649 (April 6, 1979), [1977-80 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,795. When proposing the registration standards, . . .

functions and thereafter, subject to further Commission review, evolve in a practical manner to fulfill additional objectives of the. Act and Commission regulations thereunder.

IV. Analysis of the NFA Application

The NFA application addresses each of the mandatory requirements for registration set forth in Section 17(b) of the Act and Part 170 of the Commission's regulations. The cumulative effect of the NFA's rules and the regulatory functions which it will assume, is to demonstrate that the Commission's registration of the NFA will benefit the public interest. The discussion which follows analyzes the nature of the public interest to be served by the NFA's registration and its specific compliance with each provision of Section 17(b) of the Act and the Commission's regulations thereunder.

A. Section 17(b) (1): Public Interest

Section 17(b)(1) prohibits the Commission from registering the NFA unless it is able to find that the NFA "is in the public interest and that it will be able to comply with the provisions of this section and the rules and regulations thereunder and to carry out the purposes of this section."[65] Commission regulations 170.1 and 170.9 reiterate the statutory standard and 170.9 in particular provides that an

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[65] 7 U.S.C. §21(b)(1) (1976).

applicant association must "conduct its affairs consistent with the public interest to be protected by the antitrust laws."[66]

In evaluating whether registration of the NFA would be in the public interest, the Commission considered whether a need for additional regulation of the commodities industry exists. Concluding that a regulatory gap exists and that coordination is lacking with respect to industry regulation of participants' financial responsibility and sales practices, the Commission then analyzed whether the role of a comprehensive futures association such as the NFA could serve the public interest by assuming self-regulatory responsibilities where a need has been identified. In this regard, the Commission examined the extent to which the NFA could more effectively or efficiently perform regulatory functions currently exercised by the Commission. In addition, the Commission considered the experience of the SEC with respect to its program to regulate broker-dealers that are not NASD or securities exchange members ("SECO program") as well as the SEC's reliance upon the NASD to perform certain self-regulatory functions similar to those proposed by the NFA.

1. Need for Effective Customer Protection

The NFA and others have asserted that the NFA's approach is the most practical and effective means to achieve a comprehensive self-regulatory program, and that its program is designed to fill a gap that currently exists in

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[66] Commission regulation 170.9, 17 CFR §170.9 (1981). See also pp. 77-80 infra.

commodities self-regulation.[67] The approach is not intended to replace the Commission's customer protection responsibilities, but to complement those duties by providing a vehicle through which commodity firms and professionals handling customer accounts will be subject to binding, uniform ethical and financial standards.[68]

The NFA approach will impose professional standards on industry participants not currently subject to self-regulatory ethical and financial rules. Many firms and individuals conducting customer-related commodities businesses are not regulated by a contract market and, therefore, not subject to the audit programs or disciplinary rules imposed on contract market members. For instance, 35 percent of the 376 FCMs registered with the Commission as of May 29, 1981, were not members of a contract market; neither were 99.24 percent of the 1,961 Commission-registered CTAs nor 98.83 percent of the 1,110 registered CPOs.[69] Further, the number of contract market member FCMs remained relatively constant (declining from 217 to

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[67] See Prepared Statements of Messrs. Morgan, Sander, Weiner and Magnussen at 5, 2-3, 2-3 and 6, 1-2, and 3-4, respectively. See also comment letters from the CME and Maduff.

[68] See, e.g., Prepared Statement of Mr. Melamed at 16.

[69] As of May 29, 1981, there were 32 firms that were registered as both CTAs and FCMs under the same name. Seventeen of those CTA/FCMs were not members of any contract market. Similarly, there were-19 CPOs that were also registered as FCMs, and 13 of those dual registrants were not contract market members.

205) during the period of August 1979 through. August 1980, while the number of FCMs which were not members of any contract market increased by approximately 40 percent (from 108 to 149).[70]

a. Financial Monitoring

Those FCMs which are not regulated by a contract market have been the cause of disproportionate compliance problems that might have been avoided . . .

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[70] In the ten years since 1970, the average volume of funds in segregation per firm (exchange member and non-exchange member) increased 4,000 percent from $.2 million in 1970 to $8.7 million in 1980, as shown in the following chart:

YEAR	AVERAGE FCM SEGREGATION	$ CHANGE	% CHANGE FROM PRECEDING YEAR
1970 *	$ 213,517		
1971 *	459,209	$ 245,692	115%
1976 *	2,105,809	1,646,600	359%
1979	4,950,000	2,844,191	135%
1980	8,737,286	3,787,286	77%

* See 42 FR 27167 (May 26, 1977).

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(Pages 29-32)

. . . ever, would be jeopardized if the NFA did not have provisions which, in effect, compel NFA membership by industry participants.

While the Commission has statutory discretion to register a futures association which requires membership by all potential regulatees, it also has authority to regulate those persons and firms that do not wish to be members of any voluntary futures association.[94] Thus, the Commission itself could directly impose and enforce business conduct and financial standards on those industry participants transacting customer business that are not association members. The Commission believes, however, that this approach would be less effective than a self-regulatory approach and that it would restrict the time which the Commission and its staff could devote to other statutory responsibilities that the Commission must fulfill, including those noted above.[95] The Commission believes, therefore, that the NFA approach should be a more effective method of ensuring adequate customer protection and offers the means to provide a level of customer protection responsive to the needs identified above. Moreover, in light of the NFA proposal and the clear statutory mandate favoring self-regulation by a registered futures association, the

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[94] See 7 U.S.C. §§21(d) and (e) (1976).

[95] See Prepared Statements of Messrs. Melamed, Morgan, Isaacson, Siebens and Weiner at 13-14, 11-12, 3, 5, and 2, respectively. See also comment letters from the CME, NAFTA, and Thomte.

Commission believes its reliance solely on direct Commission regulation of potential NFA members would be inappropriate.

In this regard, the Commission expects, that, as the NFA implements its regulatory programs, the Commission will be able to reallocate portions of its staff resources from the direct auditing functions which it now performs to other priorities (e.g., oversight of the exchange-traded options pilot program, greater scrutiny of existing self-regulatory programs, review of contract market rule proposals and applications for designation) and to more vigilant enforcement against all fraudulent activities, whether conducted on or off the commodity exchanges. The Commission believes that the direct regulation of retail sales practices and financial activities by both the Commission and a futures association necessarily would result in duplicative regulatory efforts.[96] It would result neither in cost efficiencies nor allow the Commission's staff the necessary time to develop other Commission programs that could enhance fair, competitive and efficient commodity futures trading.[97]

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[96] To provide biennial reviews of retail sales activities of every FCM, CPO and CTA, it is projected that the Commission would need to place at least 40 additional auditors into the regional field offices and increase its Washington staff by six attorneys and supervisors. The Commission, however, has no realistic expectation that such additional resources might be made available to it for these purposes.

[97] Justice also questioned in its comments whether an industry-wide insurance program might be a more effective means of providing customer protection against industry participant financial and sales practice abuses. Justice comments at 28. The

b. Complsory Contract Market Membership

The Commission also has considered whether the present structure of commodity self-regulation is effective to correct retail sales abuses.[98] In particular, the Commission examined whether it should require the contract markets to undertake the direct regulation of all FCMs, CPOs and CTAs by compelling all industry participants conducting customer business to join a contract market. The Commission considered this alternative in light of a 1978 study by the Public Interest Economic Center, which concluded that a superior alternative to registering a compulsory membership futures association would be to require all participants transacting customer business to join a contract market.[99] The Commission believes, however, that such an approach would

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Commission believes, however, that the value of such an insurance program as an alternative to self-regulation is questionable. In this regard, the Commission agrees with the NFA's observation that the NFA's program "is intended as a preventative program, unlike insurance, for example, which only comes into play after a loss occurs." Response III at 11. Moreover, the NFA also raises valid concerns as to whether "insurance premiums, absent an organization such as NFA, could be sufficiently low for smaller FCNs so as not to be a serious burden on competition." Id.

[98] See, e.g., Prepared Statement of Mr. Morgan at 5. Cf. Justice letter at 3-4, in which Justice asserts that the existing regulatory structure is adequate to regulate the industry and maximize consumer welfare.

[99] See Competition and Efficiency in the Commodity Futures Markets at 304-306.

be impractical, less effective and could impose significant competitive burdens on industry participants.

The Commission notes that the contract markets have not been inclined to expand their self-regulatory functions to include industry participants otherwise subject to what have been the traditional areas of contract market self-regulation. Moreover, to realize programs comparable to that proposed by the NFA, each contract market would have to develop programs for conducting retail sales audits of its members and routinely conduct such audits.[100] In connection with such programs, the contract markets would have to adopt and enforce more extensive rules relating to customer protection. The contract markets also would be required to regulate new categories of industry participants -- CPOs and CTAs -- in which the exchanges have had no prior direct regulatory experience. The responsibility to review contract markets' multiple rules and programs would impose a more time-consuming burden on the Commission than registering one or more associations whose principal purposes are to regulate the retail activities of specified categories of members.

Finally, the contract market customer protection rules that currently exist and which might be adoptee by each contract market could vary from exchange to exchange. Those industry participants that are members of two or more contract markets would often face conflicting exchange rules governing their customer-related activities as well as

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[100] See, p. 23 supra.

duplicative self-regulatory burdens.[101] By granting the NFA (or other futures associations) responsibility to regulate the retail sale practices and financial responsibility of specific categories of commodity firms and professionals directly, the Commission believes that the NFA will not only reduce conflicting and duplicative regulatory burdens on industry participants, but will also allow the Commission and the contract markets to reallocate more efficiently their resources to other regulatory programs.

c. Benefits of Self-Regulation by a Registered Futures Association

The Commission believes that its reliance upon the self-regulatory approach of a futures association will enable the industry to consolidate the expertise and experience of various industry segments, thereby allowing NFA readily to identify and solve industry regulatory problems. The opportunity for members to share their knowledge of developing sales practice or financial problems with a common self-regulator should encourage a response to such problems before they require Commission intervention. In this regard, the NFA will impose early warning financial reporting requirements on FCMs that are not members of any contract market. Thus, each FCM must notify, in addition to the Commission, either the NFA or its affiliated designated self-regulatory organization ("DSRO") (i.e., a . . .

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[101] Prepared Statements of Messrs. Melamed, Sandner, Stotier and Weiner at 8, 4, 2 and 2, respectively. See also comment letters from A.G. Becket, the CME and Bache.

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. . . the expense of maintaining separate arbitration facilities.[210] Moreover, by providing customers with an additional forum for the resolution of their commodity claims, the Commission anticipates that customers' reliance upon the Commission's reparation proceedings may be reduced and the pending backlog of such cases alleviated.

H. Section 17(m): Compulsory Membership

Section 17(m) authorizes the Commission to approve futures association rules requiring -- whether directly or indirectly -- all eligible persons to become members of at least one registered futures association if such a requirement is necessary or appropriate to achieve the purposes of the Act.[211] Moreover, the Commission may make that determination and give its approval notwithstanding any other provision of law. As previously mentioned,[212] the NFA has proposed such a compulsory membership requirement with respect to Commission registered FCMs, CPOs, CTAs and agents of FCMs.[213] In the NFA's case, the compulsory membership

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[210] See Prepared Statement of Mr. Magnussen at 7.

[211] 7 U.S.C. §21(m) (Supp. III 1979).

[212] See pp. 4-5 supra.

[213] In addition, APs affiliated with a member FCM or agent must themselves register with or be members of the NFA. Bylaw 301(a).

requirement is indirect. Once joining the NFA, members would be prohibited from engaging in any custcmer-related business with, or on behalf of, any non-member (or suspended member) FCM, CPO, CTA, or agent that is neither a member of another registered futures association nor otherwise exempted from this prohibition.[214]

The issue concerning the Commission's authority to approve rules compelling membership in a futures association surfaced in 1977, when the NFA put forward its proposed approach to ensure the comprehensive effectiveness of its regulatory programs. The NFA proposed to prohibit NFA members from handling customer business for any firm not also a member of NFA,[215] thereby assuring its jurisdiction over all industry participants toward whom the NFA's programs were directed. Justice asserted at that time, however, that not only did Congress not intend Section 17 to infer compulsory membership, but also such a membership requirement was unconstitutional under the Fifth Amendment[216] and inconsistent with antitrust law. Subsection

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[214] Bylaw 1101. See also Article III, Section l(f).

[215] See letter from Mr. Johnson to Commissioner Dunn, dated January 31, 1977, with an accompanying memorandum dated January 20, 1977 from Mr. Johnson to the NFA organizing committee.

[216] See the 1977 Justice comment letter. In light of the adoption of Section 17(m) of the Act, Justice apparently no longer contends that a compulsory membership requirement would be unconstitutional. See Comment letter from Justice. In 1977, Justice relied on several Depression-era cases that involved statutes

(m) was added to Section 17 by the Futures Trading Act of 1978[217] to settle the question whether the Commission has the authority to register a futures association which provides for mandatory membership.

In enacting current Section 17(m), Congress took note that:

> This objective [of effective self-regulation] would be frustrated if futures industry professionals were free to discontinue their membership in the relevant association or associations when their own acts and practices came under scrutiny or investigation -- since a

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which the Supreme Court held to be unconstitutional delegations of legislative authority. See, e.g., Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935), which struck down a statutory provision permitting the President to approve a code of regulation proposed by a trade association for all persons engaged in the interstate buying and selling of live poultry. Since 1935, however, Congress enacted, and the Supreme Court has upheld, statutes granting greater government oversight of private association activities. See, e.g., Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940). See also Federal Power Commission v. New England Power Co., 415 U.S. 345, 352-53 (1974): "The notion that the Constitution narrowly confines the power of Congress to delegate authority to administrative agencies, which was briefly in vogue in the 1930's, has been virtually abandoned-by the Court for all practical purposes. . . ." (Marshall, J. concurring).

[217] Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 865, amending 7 U.S.C. §21 (1976).

> title III association could not investigate, discipline, or impose corrective sanctions on non-member persons and firms.[218]

Congress thus affirmatively rejected the arguments against a mandatory approach to futures association membership. Instead, Congress expressly authorized the Commission, in its discretion, to approve requirements that directly or indirectly mandate membership in futures associations in order to prevent the associations inability to enforce their standards. Then introducing the 1978 amendment, Rep. Foley stated that:

> [a]t the present time there are industry participants operating largely beyond exchange supervision which are increasing in number. Regulation of any such persons could be achieved through expansion of Commission activities or, instead, through registration of one or more futures associations which would provide a self-regulatory program under Commission oversight. The committee has left the determination of that issue to the Commission. It has, however, included an amendment which provides expressly that the Commission may approve rules for any futures association or associations that would require persons eligible for membership to become members of at least one such association, upon a determination by the Commission that such

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[218] S. Rep. No. 650, 95th Cong., 2d Sess. 31 (1978).

> rules and regulations are appropriate to achieve the purposes and objectives of the Act. Use of the authority of this amendment would be completely discretionary with the Commission.[219]

Thus, there is no longer any question that the Commission may, in registering a futures association, entertain and approve a proposal that would, in effect, mandate membership in the association.

The NFA proposal focuses on those members involved in the flow of customer orders (i.e., FCMs and their agents, CPOs and CTAs, but not floor brokers or floor traders). It is likely that most' if not all industry participants handling customer accounts will seek to join the NFA, either voluntarily, under contract market requirement or in order to do business with NFA members -- thus the compulsory effect of the prohibition. Although those not joining the NFA will not be restricted from conducting business with other non-members, the need to use contract market members for order execution services on each of the contract markets will, for all practical purposes, make non-NFA membership highly unlikely.[220]

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[219] Remarks of Rep. Foley, 124 Cong. Rec. 7206 (daily ed. July 24, 1978) (emphasis supplied). See also 1978 House Conference Report at 26-27.

[220] NFA intends to to urge all the contract markets, which themselves are expected all to be NFA members, to require their own members to join NFA. See Prepared Statement of Mr. Melamed at 19. The Commission recognizes, however, that it is

The Commission also notes that the prohibition will not be effective immediately. Rather, it will be imposed in conjunction with the phase-in of corresponding regulatory programs.[221] For example, FCM members will not be prohibited from dealing with non-member FCMs until the FCM membership and surveillance programs are in operation.[222] Accordingly, at no time will any person be subject to the prohibition against order acceptance unless the person has become an NFA member and the NFA has adopted and implemented a regulatory program with respect to that person's category of membership.

Having considered the record before it, and, in particular, the significant public interest benefits which will be realized through registration of the NFA and implementation of its self-regulatory programs, the Commission believes that NFA's membership requirement is fully appropriate to achieve NFA's objectives and the purposes and objectives of the Act. Requiring membership in a registered futures association is an essential factor in providing the effective, industry-wide customer protection that the NFA proposes. If membership were purely voluntary, those engaging in abusive practices could evade self-regulatory compliance and sanctions simply by not joining, or by resigning from, the NFA or any comparable

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not necessary that all contract markets require their memberships, to join NFA in order for the prohibition to result in virtually industry-wide NFA membership.

[221] See Response II at 4. See also p. 8 supra.

[222] Id.

organization. Effective self-regulation will, in turn, reduce the Commission's (and thus the taxpayers') increasing and costly burden to monitor the activities of the various, professionals not subject to appropriate industry regulation and to enforce compliance under the Act.

V. Section 15 Considerations

Under Section 15 of the Act, the Commission must "consider the public interest to be protected by the antitrust laws and . . . endeavor to take the least anticompetitive means" to achieve the objectives and policies of the Act in approving bylaws and rules of registered futures associations established pursuant to Section 17.[223] Thus, in reviewing the NFA's application, the has balanced the potential anticompetitive effects of the NFA's requirements and procedures, the interests to be protected by the antitrust laws, and the regulatory benefits to be derived from this proposal. The Commission is not required, however, to choose the least anticompetitive means in acting upon the NFA's application. Rather, given the Commission's statutory-responsibilities and the complexities of the commodities industry, it is incumbent upon the Commission to give due weight to the regulatory consequences of NFA registration and the interests of self-regulation.[224]

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[223] 7 U.S.C. §19 (1976).

[224] The Supreme Court has held that simple antitrust enforcement cannot be compared to the ccmplex duties of an agency that has pervasive regulatory authority. See, e.g., Gordon v. New York Stock Exchange, 422 U.S. 659 (1975). The Supreme Court has also held that public regulatory activities are not subject

In addition, the Commission notes that possible inconsistencies with antitrust law need not prevent the Commission from approving rules that, in effect, serve to compel membership in a futures association. Indeed, Section 17(m) of the Act permits the Commission to approve ccmpulsory membership rules that are necessary or appropriate to achieve the purposes and objectives of the Act notwithstanding any other provision of law. The Commission nevertheless has examined NFA's application in light of the possibility that its compulsory membership requirement may act as a disincentive to competition.

The ramifications of not registering the NFA must be considered together with any anticompetitive implications which the proposal may raise. As previously discussed, the commodities industry in general does not currently afford an adequate level of self-regulatory customer protection and, where self-regulators have adopted customer protection rules, there is a lack of uniformity in the standards and procedures provided.[225] For example, while contract markets impose

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to the same competitive requirements applicable to private commercial conduct. See, e.g., Silver v. New York Stock Exchange, 373 U.S. 341 (1963), where the Supreme Court noted that when there is direct agency review, the antitrust laws will sustain self-regulatory activity meeting a "rule of reason" standard rather than a per se test. Id. at 358, n. 12. In United States v. National Association of Securities Dealers, Inc., 422 U.S. 694 (1974), the Supreme court exempted NASD restrictions from antitrust attack because they were subject to SEC review (citing Silver).

[225] See pp. 23 and 32 supra.

minimum financial requirements on, and conduct financial audits of, their members, they rarely, if ever, intercede regarding retail sales practices. The need for industry participants to comply with multiple, conflicting regulations in itself raises barriers to free and open competition. To the extent that the NFA application raises anticcmpetitive concerns, including its provision for compulsory membership, the Commission believes that the potential for the NFA to implement a comprehensive regulatory scheme, including the prevention or elimination of anticcmpetitive and conflicting contract market regulations, will serve the public interest and clearly outweigh any anticompetitive effects.

Moreover, the Commission does not believe that regulation of industry participants is, per se, an impediment to the free and open function of the market. On the contrary, as the NFA assumes responsibility for sales practice and financial regulation and related audits of its members, the Commission believes that the NFA may relieve the contract markets of responsibility to devote substantial resources to these areas, as well as to other regulatory areas where the NFA assumes a central regulatory role (e.g., arbitration of customer grievances). In this manner, the contract markets should have available greater resources to devote to the development of new products, self-regulation of their individual trading facilities, and the development of more efficient means of handling and executing orders. The Commission strongly believes that the availability of greater resources for these purposes will foster inter-market competition.[226] Moreover, the NFA's assumption of

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[226] Similarly, Commission establishment, surveillance and enforcement of effective industry-wide measures would require the

regulatory responsibility with respect to sales practices, and financial protection -- regulatory areas where inter-market competition to provide the least burdensome regulatory environment could lead to inadequate customer protection -- should assist the industry in establishing broadly based minimal standards in these areas and thereby avoid any potential adverse consequences of competition.

In conclusion, the Commission has considered the potential anti-competitive effects of the NFA proposals as well as the benefits to be derived, particularly in light of the Commission's other statutory responsibilities and resources. The Commission has found NFA's proposals to be in the public interest and the compulsory membership aspect to be fully, appropriate under the Act. Moreover, the Commission believes that the NFA's regulatory approach will strengthen the industry's integrity and foster competition. Accordingly, the Commission believes that the regulatory and public interest advantages expected to flow from registration of the NFA outweigh any potential anticcompetitive consequences.

VI. Conclusions and Findings

The NFA has submitted an application for a viable futures, association whose registration will be in the public interest. While the proposal as submitted does not provide for immediate implementation of the NFA's regulatory functions, the regulatory framework set forth in the application meets the

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Commission to redirect its limited resources and, consequently, jeopardize other Commission programs that could foster efficient, competitive and fair commodities markets.

standards established by Section 17 of the Act and Part 170 of the Commission's regulations.

As the NFA develops its regulatory programs and related rules, final implementation of such programs and rules will be subject to the review requirement of Section 17(j) of the Act.[227] Thus, the Commission's role with respect to the NFA will be an ongoing one. Additionally, the Commission will carefully monitor other aspect s of the NFA's rules which have raised concerns to determine whether in operation, as well as has been presented by the NFA, they will conform to the statutory standards.

The Commission has carefully studied the application and supplemental letters submitted by the NFA, written comment letters from the public and the testimony presented at the June 4, 1981 hearing. From this analysis, the Commission concludes that the NFA has demonstrated its ability to comply with Section 17 of the Act and Part 170 of the regulations, that it will promote fair and open competition among its members and otherwise further the purposes of the Act, and that it appears able to conduct its affairs consistent with the public interest to be protected by the antitrust laws. On this basis, the Commission is able to conclude that the NFA has met all of the requirements for registration set forth in the Act and the Commission's regulations thereunder, particularly those set forth in Section 17 and Part 170 thereunder.

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[227] 7 U.S.C. §21(j)(1976).

Accordingly, the Commission hereby orders that the registration of the National Futures Association is granted and that the Articles, Bylaws, Compliance Rules, Code of Arbitration and Financial Requirements contained in its Registration Statement are approved.

Issued in Washington, D.C., this 22nd day of September 1981 by the Commission (Commissioners Dunn, Gartner and Stone; Chairman Johnson did not participate).

/s/_____
Jane K. Stuckey
Secretary of the Commission

APPENDIX D

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

[Dated March 30, 1998]

Nos. 97-1975 and 97-1976

GLENN DAMATO, DEBORAH DAMATO, ANN DE LA GARZA, et al., *Plaintiff's-Appellants*,	)
v.	)
MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED, JOHN HERMANSON, FIRST COMMERCIAL FINANCIAL GROUP, INCORPORATED, et al., *Defendants-Appellees*.	)

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division
Nos. 94 C 3041 and 94 C 3143
The Honorable lames C. Holderman, Judge Presiding

BRIEF OF COMMODITY FUTURES TRADING COMMISSION AMICUS CURIAE

INTEREST OF THE COMMODITY FUTURES TRADING COMMISSION

The Commodity Futures Trading Commission ("CFTC") is the independent federal agency created by Congress in 1974 to administer and enforce the Commodity Exchange Act ("CEA"), 7 U.S.C. § 1, et seq. The CEA provides an exclusive and comprehensive regulatory scheme for regulation of commodity futures and commodity options transactions. Implicit in the CFTC's statutory mandate is its responsibility to ensure that the provisions of thc CEA are interpreted in a manner consistent with Congressional purposes and sound public policy.

By order dated February 13, 1998, this Court invited the CFTC to submit a brief amicus curiae in this appeal. The Court asked the CFTC to address the circumstances under which §22 (a) of the CEA, 7 U.S.C. § 25(a), creates a private cause of action against defendants who aid and abet persons violating that section.[1] In that regard, the Court directed the CFTC's attention to two district court cases within the Seventh Circuit which conflict with respect to that issue. These cases are In re Lake States Commodities, Inc., 936 F. Supp. 1461, 1466-68 (N.D. Ill. 1996) and In re ContiCommodity Serv. Inc., Sec. Litig., 733 F. Supp. 1555, 1567 (N.D. I11. 1990), rev'd on other grounds, sub nom. Brown v. United States, 976 F.2d 1104 (7th Cir. 1992).

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[1] For purposes of this brief, after the initial reference to a CEA provision, it will be referred to subsequently by the CEA's internal section numbering rather than to its numeration in the United States Code.

ISSUE PRESENTED FOR REVIEW

Does the private right of action for aiding and abetting that is provided for under § 22(a) of the CEA apply to persons who "aid [and] abet" a violation of § 22(a), even if such aiders and abettors do not independently satisfy the requirements of subsections (A) through (D) of the statute?

NATURE OF THE CASE

The CFTC, as amicus curiae, adopts no particular version of the facts and takes no position as to which party should ultimately prevail on this appeal. Instead, the CFTC's concern is that the relevant statutory provision be properly interpreted and applied. Accordingly, this brief will confine itself to the legal question raised by the Court.

ARGUMENT

I. Introduction

Section 22(a)(1) provides:

> Any person . . . who violates this Act or who willfully aids, abets, counsels, induces, or procures the commission of a violation of this Act shall be liable for actual damages resulting from one or more of the transactions referred to in subparagraphs (A) through (D) of this paragraph and caused by such violation to any other person–

(A) who received trading advice from such person for a fee;

(B) who made through such person any contract of sale of any commodity for future delivery (or option on such contract or any commodity); or who deposited with or paid to such person money, securities, or property (or incurred debt in lieu thereof) in connection with any order to make such contract;

(C) who purchased from or sold to such person or placed through such person an order for the purchase or sale of–

(i) an option subject to section 4c of this Act (other then an option purchased or sold on a contract market or other board of trade);

(ii) a contract subject to section 19 of this Act; or

(iii) an interest or participation in a commodity pool; or

(D) who purchased or sold a contract referred to in subparagraph (B) hereof if the violation constitutes a

> manipulation of the price of any such contract or the price of the commodity underlying such contract.

Section 22(a) of the CEA provides an express private right of action for damages resulting from substantive violations of the Act. It identifies the persons potentially liable for damages as "any person who" violates the CEA or "who willfully aids, abets, counsels, induces, or procures the commission of a violation of this Act." The statute also defines and limits the universe of plaintiffs who have standing to sue for damages. See Indemnified Capital Investments, SA. v. R. J. O'Brien & Assoc,. Inc., 12 F.3d 1406, 1409 (7th Cir. 1993) (holding that, to establish standing, the "injury in fact" must be directly to the plaintiff). In subsections (A) through (D), § 22(a) also limits the damages recovered under the private right of action to those resulting certain specified transactions. Those transactions include instances in which the plaintiff received trading advice or purchased futures contracts, commodity options or an interest in a commodity pool from "such person[s]" liable under the Section.

The subject of this brief is the applicability of the "such person[s]" language contained in subsection (A) through (D) of § 22(a) to aiders and abettors. Specifically, this case raises the question whether the aider or abettor must have provided trading advice or sold futures, options or a pool interest directly to the plaintiff under § 22. As this Court is aware, this issue is the subject of conflicting opinions within this circuit.

The district court below ruled that plaintiffs-participants in a commodity pool[2] -- were precluded as a matter of law from stating claims of fraud pursuant to § 22(a)(1)(C)(iii) against First Commercial Financial Group, Incorporated, a futures commission merchant ("FCM")[3] that was alleged to have aided and abetted the persons who sold the commodity pool interests to the plaintiffs. Damato, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al., 878 F.Supp. 1156 (N.D. Ill. 1995). Relying on the reference to "such persons" in subsections (A) through (D), the district court held that "the only persons subject to a private right of action under § 22(a)(1)(C)(iii) of the CEA are the persons who sold or took orders for interests in the commodity pool." Id. at 1161.

The district court decision was consistent with the ruling in In re Lake States Commodities, Inc., supra. The Lake States court found that under the "plain language" of § 22(a), a plaintiff must demonstrate that a defendant is one of the "such person[s]" listed in § 22(a)(1)(A)-(D) in order to hold the defendant liable under the CEA. 936 F. Supp. at

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[2] A "commodity pool" is an investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity futures or option contracts. CFTC Glossary, pg. 9 (CFTC 1997).

[3] A "futures commission merchant" is an entity or person engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery who, in that connection, accepts money or extends credit to margin, guarantee or secure any trades or contracts that result therefrom. CEA § 1a(12), 7 U.S.C. § 2.

1467. Applying those provisions to the facts, the court stated that unless the putative defendant FCM sold interests in the commodity pool to the plaintiffs, or accepted orders for such purposes, no cause of action under § 22(a) would lie. Id.

The court in Lake States declined to borrow the broad definition of aiding and abetting in § 13(a) of the CEA, 7 U.S.C. § 13c(a), finding that § 13(a) empowers the CFTC to bring judicial, as well as administrative, actions against aiders and abettors of § 22(a) violations. Id. at 1467-68. The court also made clear that, while it recognized that § 13(a) was amended in 1983 to remove language that limited its applicability to administrative proceedings, in its view that change did not override the express provision of§ 22(a)(2), 7 U.S.C. § 25(a)(2) that states that § 22 provides the "exclusive remedies [sic] under this Act available to any person who sustains loss as a result of any alleged violation of this Act." Id. The court in Lake States dismissed the CEA claims against the aiding and abetting FCM, concluding that the plaintiffs had failed to allege that it was directly involved in any of the acts proscribed in § 22(a)(1)(A)-(D). Id. at 1468.

In contrast, the district court in In re ContiCommodity Servs. Inc., Sec. Lit., supra, reached a different conclusion. ContiCommodity involved a challenge to the legal sufficiency of customers' claims against Continental Grain Company ("Continental"), the parent company of an FCM, and individual defendants associated with ContiCommodity Services, Inc. ("Conti"), the FCM, for the alleged unauthorized trading and wrongful closeout of the customers' futures positions.

Defendants argued in that case that since neither Continental nor the Conti individual defendants sold futures contracts to the plaintiffs, they were not "such person[s]" within the meaning of § 22(a)(1)(A)-(D) and thus could not be liable under that Section. The district court rejected that argument concluding that § 13(a), the CEA's general aiding and abetting provision. "enables an injured party to bring a court suit against an aider and abetter, inducer, combiner, etc. who was not the 'such person' under § 22(a)(1)(A)-(D)." 733 F. Supp at 1567. Accordingly, the district court held that the customers could state claims against Continental and the Conti individual defendants--the alleged aiders and abettors--under § 22(a). Id.

II. A Plaintifff Who Alleges That A Defendant Aided And Abetted One Of "Such Person[s]" Specified In § 22(a)(1) May State A Private Cause Of Action For Damages Against That Aider And Abettor Under § 22(a)(1).

Section 22, the express private right of action provision of the CEA, was added to the CEA by Section 235 of the Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294, 2322-24. Discussing the express private right of action that was embodied in the bill, the House Agriculture Committee stated that it was "of the view that the right of an aggrieved person to sue a violator of the Act is critical to protection of the public and fundamental to maintaining the credibility of the futures market." H.P. Rep. No. 565, Part 1, 2d Sess. at 56-57 (1982). The legislative history of § 22 confirms that its passage was intended to resolve questions left open by the Supreme Court's decision in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353

(1982), which recognized a private right of action for violations of certain provisions of the CEA. H.R. Conf. Rep. No. 954, 9th Cong., 2d Sess. at 53. The bill was also designed to eliminate ambiguity concerning private causes of action under the CEA. Id. at 51-53.

Consistent with this purpose to authorize private actions against violators of the CEA, 22(a) provides broadly for the liability of "[a]ny person . . . who violates this Act," so long as the damages sued for are "actual damages resulting from one or more of the transactions referred to in subparagraphs (A) through (D) of this paragraph and caused by such violation to any other person." Thus, the limitations on liability that are contained in § 22(a) are directed toward questions of causation and standing and were intended only to ensure that the "violation" for which suit is brought is both causally and transactionally connected to actual damages suffered by the putative plaintiff.

Where such a connection exists between a plaintiff's damages and a violation by a primary violator, the statutory language supports the conclusion that an aider and abettor of the primary violator is liable. Section 22(a)(1) requires only that the damages be "caused by such violation to" one of the listed categories of persons and that the damages result from one of the "transactions" delineated in subparagraphs (A)-(D). Importantly, § 22(a)(1) does not provide that damages to one of the listed categories of persons must be caused by the person charged under § 22(a)(1), but only that they must be "caused by such violation" (emphasis supplied).

By definition, an aider and abettor knowingly contributes to a primary wrongdoer's violation, rather than committing an independent violation of his or her own. See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176 (1994) ("[A]iding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity, aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to chose who do."). If the primary violator's wrongdoing satisfies the requirements of subparagraphs (A) through (D) of § 22(a)(1), then the plaintiff's damages are "caused by such violation," irrespective of whether the aider and abettor independently would satisfy the requirements of subparagraphs (A) through (D).

Indeed, requiring that the aider and abettor be "such person" within the meaning of subparagraphs (A) through (D) renders § 22(a) internally inconsistent and does violence to the clear intent of § 22. As indicated above, § 22(a)(1)(A)-(D) defines the persons who are appropriate plaintiffs under the CEA. It also sets forth the damages that may be recovered in a private right of action. It limits recovery to damages caused by the violation and "resulting from one or more of the transactions referred to in subparagraphs (A) through (D)." If "such person" under subparagraphs (A) through (D) referred to in the aider and abettor (i.e., if the aider and abettor were required to have the direct relationship with the plaintiff], then the only damages recoverable would be those resulting from the transaction between the aider and abettor and the plaintiff. This is nonsensical, because the plaintiff's damages result not from the act of the aider and abettor in providing trading advice or selling futures, options

or pool interests to the plaintiff, but from the violation itself by the primary violator. It is also clearly inconsistent with the language of § 22(a)(1) which requires that the damages be "caused by such violation." In other words, it is the violation of the CEA by the primary violator that gives rise to the damages recoverable under § 22. Thus, for the language of § 22 to make sense, "such person" in subparagraphs (A) through (D) must refer to the primary violator and not the aider and abettor.

In sum, the plain language of § 22(a) creates liability for an aider and abettor if (i) he or she assists in a violation of the Act, (ii) the plaintiffs' damages are caused by that underlying violation and (iii) the damages result from one of the transactions set forth in subparagraphs (A)-(D). There is no independent requirement that both the primary violator and the aider and abettor directly with the plaintiff.

This conclusion is reinforced when one considers § 22(a) in light of general principles of aiding and abetting, which it is reasonable to assume were intended by Congress to be operative in the context of § 22(a). Judicial interpretations of aiding and abetting teach that the aider and abettor is, by definition, distinct from the primary violator. Fustok v. ContiCommodity Servs., Inc., 618 F. Supp. 1069, 1072 (S.D.N.Y. 1985) (person may be held liable under CEA for aiding and abetting when he assists another to commit a prohibited act); United States v. Pino-Perez, 870 F.2d 1230, 1231 (7th Cir.), cert. denied, 493 U.S. 901 (1989) (when crime is so defined that participation by another is necessary, other participant is not aider and abettor).

To be liable for aiding and abetting, a wrongdoer need not satisfy independently all of the elements that would be necessary to establish primary liability. See United States v. Stanley, 765 F. 2d 1224, 1242 (5th Cir. 1985), rehearing denied U.S. v. Spiczak, 772 F.2d 904; Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1119 (W.D.Mich. 1996) (distinguishing primary violations from aiding and abetting liability). For criminal aiding and abetting liability to attach, it is not even necessary that an aider and abettor know all the details of the crime. United States v. Grubczak, 793 F.2d 458, 463 (2d Cir. 1986). As this case law shows, the aider and abettor's liability arises not by virtue of being an additional principal, but by knowingly providing substantial assistance to the unlawful activity.

The conclusion that § 22(a)(1) does not require that an aider and abettor independently satisfy subparagraphs (A) through (D) also draws support from § 13(a) of the CEA.[4]

See Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 570 (1995) (identical words used in different parts of the same act generally are intended to have the same meaning). Section 13(a) was amended as part of the Futures Trading Act of 1982, the same legislation that created § 22. In that year, Congress amended § 13(a) to remove language restricting its application to administrative proceedings brought under the CEA. The legislative history reflects that Congress intended with this change to extend § 13(a) to "both court proceedings and administrative proceedings under the Act." H.R. Rep. No. 565, Part 1, 97th Cong., 2nd Sess. at 104-105. Since both § 13(a) and § 22(a)(1) refer to one who "willfully aids, abets, counsels . . . induces, or procures the commission of

---

[4] Section 13(a) of the CEA states that:

> Any person who commits, or who willfully aids, abets, counsels, commands, induces, or procures the commission of a violation of any of the provisions of this Act, or of any of the rules, regulations or orders issued pursuant to this Act, or who acts in combination or concert with any other person in any such violation, or who willfully causes an act to be done which if directly performed or omitted by him or another would be a violation of the provisions of this Act or any of such rules, regulations, or orders may be held responsible for such violation as a principal.

a violation," it is reasonable to assume that this language in § 22(a)(1), like the corresponding language in § 13(a), was not intended to be limited in its application to those who satisfy subparagraphs (A) through (D) of § 22(a)(1).

Indeed, had Congress intended in drafting § 22(a) to graft on to aider and abettor liability substantial and unprecedented limitations on its scope, one would expect to find some evidence of such an intent in the legislative history of the 1982 Act. No such evidence exists. To the contrary, Congress broadened the application of aider and abettor liability in § 13(a) to permit its use in "court proceedings." H.R. Rep. No. 565 at 105.

The Commission's interpretation of the scope and application of the aiding and abetting language in § 22(a) is not inconsistent with Congress' intent that § 22(a) confer a limited private right of action for damages. Under the view that we urge herein, the alder and abettor still must aid and abet a primary violator who stands in one of the defined required transactional relationships with the plaintiff.

Nor would the interpretation that we urge here expand aiding and abetting liability under § 22(a) beyond conventional and recognized bounds. One who seeks to prove aiding and abetting faces a considerable hurdle. Aiding and abetting liability requires that the alleged aider and abettor know that he is assisting a wrongful act. In re Temporomandibular Joint (TMJ) Implants, 113 F.3d 1484, 1495 (8th Cir. 1997). He also must take an active role in the misconduct because he must give, at a minimum, substantial assistance to the primary violator's wrongdoing. Walck v. American Stock Exchange, Inc., 687 F.2d 778, 791 (3d Cir.

1982). Where all the prerequisites to aiding and abetting liability are alleged, it would be contrary to the remedial purposes of the CEA to construe subsections (A) through (D) to preclude liability on the part of one who aids and abets another person who satisfies those criteria.

The private right of action granted by § 22 advances important policy objectives. It provides a means of compensating persons injured through commodities trading while at the same time enforcing compliance with the CEA. Given the limited resources of the government, private rights of action are an important supplement to government enforcement actions in helping to ensure lawful conduct in the commodities industry. See Curran, 456 U.S. 384-85 (private litigation is a valuable component of industry self-regulation). The express recognition of the need for aider and abettor liability in private actions under the CEA reflected in § 22 should not be undercut by an unduly restrictive reading of that Section.

CONCLUSION

For the foregoing reasons, the CFTC respectfully submits that a valid cause of action may be stated under § 22 of the CEA against one who aids and abets a violation of § 22, when the primary violator satisfies the requirements of § 22(a)(l)(A) through (D).

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Dated: March 30, 1998

APPENDIX E

SUPERIOR COURT OF NEW JERSEY

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583 NEWARK AVENUE
JERSEY CITY, N.J. 07306
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CHAMBERS OF
SEYMOUR MARGULIES
JUDGE

NOT FOR PUBLICATION WITHOUT THE APPROVAL OF THE COMMITTEE ON OPINIONS

LETTER OPINION

October 31, 1996

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William T. Marshall, Jr., Esq.
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Re: **Equidex, Inc. v. National Futures Association**
Docket No. HUD-L-9424-92

Dear Counselors:

Mr. Cole wanted a one year subscription to the Commodex System so he could collect information via the TYMNET data network using his PC and modem. It's an on-line service for investors interested in the commodities line. He addressed his order to "Commodex, Equidex Inc., 7000 Boulevard East, Guttenberg, NJ." Being dissatisfied with the service, he wanted Equidex to refund his money and asserted a claim against Equidex.

Equidex denied that Cole was its client and denied liability for the Commodex System, asserting that its operation is separate from Equidex, though under the common control of Philip Gotthelf.

Equidex is a member of NFA (National Futures Association) as a Commodity Trading Advisor.

Cole demanded arbitration with NFA against Equidex under the NFA Code of Arbitration. An award was entered back in 1990 against Equidex. Equidex challenged the jurisdiction of the arbitrators and has not yet paid the award.

In 1991 a settlement agreement was executed by Equidex and NFA.

Among other clauses, it provided:

> WHEREAS, the parties hereto desire to settle any and all claims against each other, the parties having negotiated an amicable resolution.
>
> . . .
>
> NFA agrees not to initiate any disciplinary action against Equidex for the activities of Commodex unless there is evidence establishing that either an agency or apparent agency relationship exists between the two entities (excepting use of existing stationery and listing of parties on same stationery for the period of eighteen (18) months as set forth in paragraph 1 herein).
>
> If Equidex decides to file an action against Cole to vacate the arbitration award pursuant to Section 10 of the Federal Arbitration Act, NFA will not file an amicus curiae brief on behalf of Cole.

Because Equidex has not paid the arbitration award, NFA suspended it pursuant to the second sentence of Section 10(g) of the NFA's Code of Arbitration which provides in its entirety:

> The failure of a Member or employee thereof, or Associate, to comply with an award shall be grounds for disciplinary action under NFA Compliance Rules (see Compliance Rule 2-5). When any Member or employee thereof,

> or Associate, fails to comply with an award within 30 days from the date of service of the award by NFA or such other period as specified in the award, and unless there is pending a request to modify the award under Section 10(c) or an application to vacate, modify or correct the award in a court of competent jurisdiction, that Member or Associate may, on seven days written notice, be summarily suspended by the President until such award has been satisfied.

Equidex brought the present action against NFA alleging that the suspension violated the settlement agreement; that NFA had agreed not to initiate a disciplinary action against Equidex for the activities of Commodex unless the agency relationship was established; that a suspension is a disciplinary action; and that the dispute involving Commodex was resolved and any claims were settled.

The agreement was reached after the parties had been in Federal litigation.

The settlement agreement does not expressly refer to the arbitration award although it was a material factor in the dispute. There was voluminous documentation submitted on the cross motions of the parties for summary judgment. Facts are not in dispute. The principal issue concerns the extent, if any, to which the settlement agreement prevents NFA from suspending Equidex. Equidex never administratively appealed the award; nor did it judicially challenge the award although the code provides for these procedures. The suspension was not for any wrongful conduct of, or

concerning, or relating to Commodex but for failing to pay the arbitration award. The payment of the award would have prevented or terminated the suspension. Any fear that payment would be an admission of fault could have ben alleviated by a conditional payment - or one under reservation of rights.

As a member of NFA, Equidex is bound by its rules - its rules are in the nature of agreements with all its members. It has compliance rules, enforcement of which affect the integrity of the organization and its members.

The settlement agreement does not bar the suspension of Equidex.

If the parties did not intend to allow NFA to enforce this past award, they should have said so. The language used limiting the fight of NFL "to initiate" any "disciplinary" action unless evidence of agency existed is as to future Commodex activities.

It is not reasonable or legally sound to assume that Equidex intended not to obey the order of the arbitrators. Each of the numbered paragraphs of the settlement agreement refer to in futuro conduct - not past conduct. The word "initiate" which is in paragraph 6 is also in paragraph 4; both speak in futuro. If Equidex had intended to simply disregard the award, there would be no reason for paragraph 8. Paragraph 8 allows for an application to vacate the award. Equidex was to pay it or seek to vacate it. It did neither. Paragraph 8 expressly refers to Section 10 of the Code of Arbitration. This is the very section that allows for

suspension if there is no application to vacate. The, parties were, in fact, aware of the provisions of Section 10.

Plaintiff has pleaded a variety of claims founded in the theory that the suspension was unlawful but has not asserted a claim to vacate the award.

The suspension is lawful and precludes the plaintiff from any claims for relief. Defendant's motion is granted; plaintiff's is denied. Submit order.

Very truly yours,

/s/_____
Seymour Margulies, J.S.C.

SM:bc

APPENDIX F

CHAPTER 2

PURPOSES

NFA [¶ 4023] Bylaw 201. Purposes

NFA's purposes are as stated in Article III of NFA's Articles of Incorporation (hereinafter "Articles").

ARTICLES OF INCORPORATION
OF
NATIONAL FUTURES ASSOCIATION

ARTICLE III: PURPOSES

[¶ 3023.1] Section 1: Fundamental Purposes.

Subject to the limitations in Section 2 of this Article, the fundamental purposes of NFA are to promote the improvement of business conditions and the common business interests of persons engaged in commodity futures activity by (i) undertaking the regulation of persons that are members of NFA (hereinafter "Members") as set forth in this Article; (ii) relieving the Commodity Futures Trading Commission (hereinafter "Commission") from the substantial burden of direct regulation in such matters; and (iii) facilitating the allocation of increased Commission resources to contract market designations, approval of contract market rules, registration of industry professionals and other duties of the Commission affecting the growth of the commodity futures

industry and the public's ability to avail itself of the industry's expanding services. Actions of NFA to effectuate these purposes may include:

(a) Public Interest.

The adoption, administration and enforcement as to the following persons of requirements regarding fair practice and designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect the public interest:

-- Members that are registered with the Commission as Futures Commission Merchants, Commodity Pool Operators, Commodity Trading Advisors, Introducing Brokers or Leverage Transaction Merchants; and

--Associates (see Article XVIII).

APPENDIX G

CHAPTER 11

DOING BUSINESS WITH NON-MEMBERS

NFA [¶ 2391 Bylaw 1101. Prohibition.

No Member may carry an account, accept an order or handle a transaction, in commodity futures contracts, for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an FCM, Introducing Broker, Commodity Pool Operator, Commodity Trading Advisor, or Leverage Transaction Merchant, and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or any other person, unless (a) such non-member of NFA is a member of another futures association registered with the Commission under Section 17 of the Act, or is exempted from this prohibition by Board resolution, or (b) such suspended Member is exempted from this prohibition by the Appeals Committee. No Member may accept orders in commodity futures contracts to cover leverage transactions, for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as a Leverage Transaction Merchant, unless (a) such non-Member is a member of another futures association registered under Section 17 of the Act, or is exempted from this prohibition by Board resolution, or (b) such suspended Member is exempted from this prohibition by the Appeals Committee.

[See Interpretive Notice at ¶ 9007.]

CFTC Reg. § 166.3 Supervision.

Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function), relating to its business as a Commission registrant.

APPENDIX H

[¶9007] Compliance With Bylaw 1101
(Staff, March 19, 1987)

INTERPRETIVE NOTICE

Mandatory membership in NFA is the cornerstone of NFA's regulatory structure. From the earliest stages of its formation, NFA's founders recognized that the creaction of a meaningful and effective industry-wide self-regulatory organization would be completely impossible unless all persons required to be registered as FCMs, IBs, CPOs or CTAs were required to be Members. The founders of NFA considered the issue to be of such critical importance that they not only prohibited the conduct of customer business with non-Members through NFA Bylaw 1101, but included that prohibition as one of NFA's fundamental purposes in Article III, Section l(f) of NFA's Articles of Incorporation. (Exhibit N).

Given the importance of the mandatory membership concept, NFA Bylaw 1101, which tracks the language of Article III, Section l(f), states the prohibition in the strongest possible terms. [See ¶4239 for the text of Bylaw 1101.]

The rule by its terms imposes strict liability on any Member conducting customer business with a non-Member that is required to be registered. The rule does not require proof that the Member firm was at fault or failed to exercise due diligence--simply that it transacted customer business with a non-Member that is required to be registered. NFA Bylaw

1101 requires Members to make two determinations: whether it is doing business with an entity which is required to be registered, and, if so, whether that person is a Member of NFA. The second of these determinations is relatively simple. Any member can call NFA's Information Center at a toll-free number (800-621-3570) to receive current and accurate information concerning the membership status of any person. The determination of whether a particular person is required to be registered can obviously be much more difficult. Any Member could, despite its best efforts, be transacting customer business with a person who is actually required to be registered as an FCM, IB, CPO or CTA. In such a case, the Member is in technical violation of the strict liability terms of NFA Bylaw 1101.

A review of NFA policy, procedures and past disciplinary actions, however, clearly indicates that NFA Bylaw 1101 has not been enforced unreasonably. In making its recommendations in cases involving apparent Bylaw 1101 violations, staff has consistently not relied on the strict liability standard set by the rule itself. Staff has recommended the issuance of complaints in Bylaw 1101 cases in which the evidence indicates that the Member knew or should have known of the violation. Of course, under NFA Compliance Rules, the ultimate decision of whether a particular violation of NFA rules warrants prosection rests with the Members of NFA's Business Conduct Committee ("BCC"). BCC Members exercise their informed business judgment in making these decisions, and are certainly aware that some violations of Bylaw 1101 may occur in spite of reasonably diligent efforts to comply with the rule.

The question of whether a Member should have known of a violation of NFA Bylaw 101 depends in large part on the adequacy of its procedures to prevent such violations. Through it would be impossible to describe all of the situations which should put a Member on notice that a particular person is required to be a Member of NFA, there are certain minimal steps which should be taken to reduce the possibility of a violation of NFA Bylaw 1101:

1. FCM Members should ensure that all omnibus accounts they carry are held by FCM Members of NFA;

2. Each Member should review the list of CFTC registrants with which it does business to determine if they are NFA Members;

3. Each Member should review its list of customers. If a customer's name indicates that it may be engaged in the futures business, the Member should inquire as to its registration and membership status;

4. NFA Compliance Rule 2-8(e) requires that FCM or IB Members who handle accounts managed by third party account controllers, must obtain either an acknowledgment that the customer had received a disclosure document or a written statement from the account controller explaining why the disclosure document need not be provided. When the account controller has provided a disclosure document, the Member should check the

account controller's membership status. When the account controller claims an exemption from disclosure requirements, his written explanation should be reviewed to determine whether the claim on its face is valid;

5. If any customer is operating a commodity pool but claims to be exempt from registration as a CPO, the Member should verify that the customer has made the required filings with the CFTC and NFA;

6. Members should ensure that their branch offices are not seperately incorporated entities. The CFTC Division of Trading and Markets has issued an interpretive letter stating that branch offices, which are separately incorporated entities, are required to be registered as introducing brokers; and

7. FCM Members should determine whether non-Member foreign brokers for whom the Member carries accounts solicit U.S. customers for transactions on U.S. exchanges.

As mentioned above, these suggested steps do not purport to be a dispositive list of internal procedures required to prevent violation of NFA Bylaw 1101. Though under some circumstances a Member following these suggestions could still be found liable for a violation of NFA Bylaw 1101, the suggested procedures should help foster compliance with NFA Bylaw 1101 and greater protection to the investing public.

APPENDIX I

A Compliance Guide:

Futures Commission Merchants and Introducing Brokers

National Futures Association

NFA: A Brief History

National Futures Association (NFA) became operational on October 1, 1982, as the first industrywide self-regulatory organization for the rapidly growing futures industry. The events which led to its creation, however, had their beginning some eight years earlier with the enactment of the Commodity Futures Trading Commission Act (Act) of 1974.

That Act which amended the existing law governing futures trading simultaneously established the Commodity Futures Trading Commission (CFTC) as an independent agency with exclusive jurisdiction over futures trading and authorized the creation, by the futures industry, of "registered futures associations." In addition, the Act provided for the regulation of sectors of the futures industry not previously subject to regulation.

It was clearly the hope of Congress that, given the opportunity and necessary authority, a self-regulatory organization could play a major role in assuring compliance with the Act's requirements and in achieving its objectives.

Notwithstanding extensive groundwork by members of the futures industry, it was not until 1978, when Congress specifically authorized mandatory membership, that the last major obstacle to the establishment of an effective self-regulatory organization was removed. In March of 1981, application was made to the CFTC for designation as a registered futures association. That registration was granted in September of 1981 and a year later NFA officially began operations.

Responsibilities of NFA

NFA's primary responsibility is to assure, through self-regulation, high standards of professional conduct and financial responsibility on the part of the individuals and organizations that are its Members. In addition to Futures Commission Merchants (FCMs) and Introducing Brokers (IBs), these include Commodity Pool Operators (CPOs), Commodity Trading Advisors (CTAs) and Associated Persons (APs) of any of the foregoing.

The key to NFA's regulatory effectiveness is the requirement, Bylaw 1101, which stipulates, that no NFA Member may accept a futures or an option on futures order from another person acting on behalf of a customer unless that other person is a member of a registered futures association. NFA is currently the only such association.

Simply stated, this means that persons who are not or do not remain qualified for NFA membership are prevented or barred from dealing with the public in a business that involves buying or selling futures or options contracts for commodity customers. This is because they will be unable to

obtain execution of their orders. This restriction is commensurate with the resolve of the futures industry that those who do not conduct their business by prescribed rules and standards shall not, in this industry, conduct business at all.

In connection with its self-regulatory responsibilities, NFA conducts periodic audits of its Members' financial and other records, monitors sales practices, and provides a mechanism for the arbitration of futures-related disputes between NFA Members and their customers. NFA also provides a mechanism for the arbitration of Member-to-Member disputes and carries out a variety of educational activities for the benefit of its Members and the investing public.

In addition, NFA is responsible for the processing of applications by futures firms and professionals for registration with the CFTC.

Further, more detailed information about NFA and its various activities is contained in the following publications, available by contacting the Information center at (312) 781-1410:

APPENDIX J

7 U.S.C. § 21.
Registered futures associations

(a) Registration statement

Any association of persons may be registered with the Commission as a registered futures association pursuant to subsection (b) of this section, under the terms and conditions hereinafter provided in this section, by filing with the Commission for review and approval a registration statement in such form as the Commission may prescribe, setting forth the information, and accompanied by the documents, below specified:

> (1) Data as to its organization, membership, and rules of procedure, and such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest; and
>
> (2) Copies of its constitution, charter, or article of incorporation or association, with all amendments thereto, and of its bylaws, and of any rules or instruments corresponding to the foregoing, whatever the name, hereinafter in this section collectively referred to as the "rules of the association".

(b) Standards for registration; Commission findings

An applicant association shall not be registered as a futures association unless the Commission finds, under standards established by the Commission, that–

(1) such association is in the public interest and that it will be able to comply with the provisions of this section and the rules and regulations thereunder and to carry out the purposes of this section;

(2) the rules of the association provide that any person registered under this chapter, contract market, or any other person designated pursuant to the rules of the Commission as eligible for membership may become a member of such association, except such as are excluded pursuant to paragraph (3) or (4) of this subsection, or a rule of the association permitted under this paragraph. The rules of the association may restrict membership in such association on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest and to carry out the purpose of this section. Rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to, or refuse to continue in such association any person if (i) such person, whether prior or subsequent to becoming registered as such, or (ii) any person associated within the meaning of "associated person" as set forth in

section 6k of this title, whether prior or subsequent to becoming so associated, has been and is suspended or expelled from a contract market or has been and is barred or suspended from being associated with all members of such contract market, for violation of any rule of such contract market;

(3) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall be admitted to or continued in membership in such association, if such person–

> (A) has been and is suspended or expelled from a registered futures association or from a contract market or has been and is batted or suspended from being associated with all members of such association or from being associated with all members of such contract market, for violation of any rule of such association or contract market which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade;
>
> (B) is subject to an order of the Commission denying, suspending, or revoking his registration pursuant to section 9 of this title, or expelling or suspending him from membership in a registered futures association

or a contract market, or barring or suspending him from being associated with a futures commission merchant;

(C) whether prior or subsequent to becoming a member, by his conduct while associated with a member, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such member, and in entering such a suspension, expulsion, or order, the Commission or any such contract market or association shall have jurisdiction to determine whether or not any person was a cause thereof; or

(D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person who would be ineligible for admission to or continuance in membership under clause (A), (B), or (C) of this paragraph;

(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such

other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such a member. For the purpose of defining such standards and the application thereof, such rules may–

(A) appropriately classify prospective members (taking into account relevant matters, including type or nature of business done) and persons proposed to be associated with members;

(B) specify that all or any portion of such standard shall be applicable to any such class;

(C) require persons in any such class to pass examinations prescribed in accordance with such rules;

(D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate;

(E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, and

other qualifications (including, in the case of an applicant for membership, financial responsibility) of the applicant and that the association shall adopt procedures for verification of qualifications of the applicant, which may require the applicant to be fingerprinted and to submit, or cause to be submitted, such fingerprints to the Attorney General for identification and appropriate processing. Notwithstanding any other provision of law, such an association may receive from the Attorney General all the results of such identification and processing; and

(F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of section 9 of this title, be deemed an application required to be filed under this section);

(5) the rules of the association assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs;

(6) the rules of the association provide for the equitable allocation of dues among its members, to defray reasonable expenses of administration;

(7) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, in general, to protect the public interest, and to remove impediments to and perfect the mechanism of free and open futures trading;

(8) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules;

(9) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any person seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include–

> (A) a statement setting forth any act or practice in which such member or other person may be

found to have engaged, or which such member or other person may be found to have omitted;

(B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation;

(C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade; and

(D) a statement setting forth the penalty imposed;

In any proceeding to determine whether a person shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based;

(10) the rules of the association provide a fair, equitable, and expeditious procedure through arbitration or otherwise for the settlement of customers' claims and grievances against any member or employee thereof: Provided, That (A) the use of such procedure by a customer shall be voluntary, (B)

the term "customer" as used in this paragraph shall not include another member of the association, and (C) in the case of a claim arising from a violation in the execution of an order on the floor of a contract market, such procedure shall provide, to the extent appropriate–

(i) for payment of actual damages proximately caused by such violation. If an award of actual damages is made against a floor broker in connection with the execution of a customer order, and the futures commission merchant which selected the floor broker for the execution of the customer order is held to be responsible under section 4 of this title for the floor broker's violation, such futures commission merchant may be required to satisfy such award; and

(ii) where the violation is willful and intentional, for payment to the customer of punitive or exemplary damages, in addition to losses proximately caused by the violation, in an amount equal to no more than two times the amount of such losses. If punitive or exemplary damages are awarded against a floor broker in connection with the execution of a customer order, and the futures commission merchant which selected the floor broker for the execution of such order is held to be responsible under section 4 of this title for the floor broker's violation, such futures commission merchant may be required to

satisfy the award of punitive or exemplary damages ff the floor broker fails to do so, except that such requirement shall apply to the futures commission merchant only if it willfully and intentionally selected the floor broker with the intent to assist or facilitate the floor broker's violation; and

(11) such association provides for meaningful representation on the governing board of such association of a diversity of membership interests and provides that no less than 20 percent of the regular voting members of such board be comprised of qualified nonmembers of or persons who are not regulated by such association.

(12) (A) such association provides on all major disciplinary committees for a diversity of membership sufficient to ensure fairness and to prevent special treatment or preference for any person in the conduct of disciplinary proceedings and the assessment of penalties.

(13) A major disciplinary committee hearing a disciplinary matter shall include–

(A) qualified persons representing segments of the association membership other than that of the subject of the proceeding; and

(B) where appropriate to carry out the purposes of this paragraph, qualified persons who are not members of the association.

(c) Suspension of registration

The Commission may, after notice and opportunity for hearing, suspend the registration of any futures association if it finds that the rules thereof do not conform to the requirements of the Commission, and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with such requirements.

(d) Fees and charges

In addition to the fees and charges authorized by section 12a(1) of this title, each person registered under this chapter, who is not a member of a futures association registered pursuant to this section, shall pay to the Commission such reasonable fees and charges as may be necessary to defray the costs of additional regulatory duties required to be performed by the Commission because such person is not a member of a registered futures association. The Commission shall establish such additional fees and charges by rules and regulations.

(e) Registered persons not members of registered associations

Any person registered under this chapter, who is not a member of a futures association registered pursuant to this section, in addition to the other requirements and obligations of this chapter and the regulations thereunder shall be subject to such other rules and regulations as the Commission may find necessary to protect the public interest and promote just and equitable principles of trade.

(f) Denial of registration

Upon filing of an application for registration pursuant to subsection (a) of this section, the Commission may by order grant such registration if the requirements of this section are satisfied. If, after appropriate notice and opportunity for hearing, it appears to the Commission that any requirement of this section is not satisfied, the Commission shall by order deny such registration.

(g) Withdrawal from registration; notice of withdrawal

A registered futures association may, upon such reasonable notice as the Commission may deem necessary in the public interest, withdraw from registration by filing with the Commission a written notice of withdrawal in such form as the Commission may by rules and regulations prescribe.

(h) Commission review of disciplinary actions taken by registered futures associations

(1) If any registered futures association takes any final disciplinary action against a member of the association or a person associated with a member, denies admission to any person seeking membership therein, or bars any person from being associated with a member, the association promptly shall give notice thereof to such member or person and file notice thereof with the Commission. The notice shall be in such form and contain such information as the Commission, by rule or regulation, may prescribe as necessary or appropriate to carry out the purposes of this chapter.

(2) Any action with respect to which a registered futures association is required by paragraph (1) to file notice shall be subject to review by the Commission on its motion, or on application by any person aggrieved by the action. Such application shall be filed within 30 days after the date such notice is filed with the Commission and received by the aggrieved person, or within such longer period as the Commission may determine.

(3)(A) Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of such action unless the Commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments).

(B) The Commission shall establish procedures for expedited consideration and determination of the question of a stay.

(i) Notice; hearing; findings; cancellation, reduction, or remission of penalties; review by court of appeals

(1) In a proceeding to review a final disciplinary action taken by a registered futures association against a member thereof or a person associated with a member, after appropriate notice and opportunity for a hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction imposed by the association)--

(A) if the Commission finds that–

(i) the member or person associated with a member has engaged in the acts or practices, or has omitted the acts, that the association has found the member or person to have engaged in or omitted;

(ii) the acts or practices, or omissions to act, are in violation of the rules of the association specified in the determination of the association; and

(iii) such rules are, and were applied in a manner, consistent with the purposes of this chapter, the Commission, by order, shall so declare and, as appropriate, after the sanction imposed by the association, modify the sanction in accordance with paragraph (2), or remand the case to the association for further proceedings; or

(B) if the Commission does not make any such finding, the Commission, by order, shall set aside the sanction imposed by the association and, if appropriate, remand the case to the association for further proceedings.

(2) If, after a proceeding under paragraph (1), the Commission finds that any penalty imposed on a member or person associated with a member is excessive or oppressive, having due regard for the public interest, the Commission, by

order, shall cancel, reduce, or require the remission of the penalty.

(3) In a proceeding to review the denial of membership in a registered futures association or the barring of any person from being associated with a member, after appropriate notice and opportunity for a hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the action of the association)--

(A) if the Commission finds that–

(i) the specific grounds on which the denial or bar is based exist in fact;

(ii) the denial or bar is in accordance with the rules of the association; and

(iii) such rules are, and were applied in a manner, consistent with the purposes of this chapter, the Commission, by order, shall so declare and, as appropriate, affirm or modify the action of the association, or remand the case to the association for further proceedings; or

(B) if the Commission does not make any such finding, the Commission, by order, shall set aside the action of the association and require the association to admit the applicant to membership or permit the person to be associated with a member, or, as

appropriate, remand the case to the association for further proceedings.

(4) Any person aggrieved by a final order of the Commission entered under this subsection may file a petition for review with a United States court of appeals in the same manner as provided in section 9 of this title.

(j) Changes or additions to association rules

Every registered futures association shall file with the Commission in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest, copies of any changes in or additions to the rules of the association, and such other information and documents as the Commission may require to keep current or to supplement the registration statement and documents filed pursuant to subsection (a) of this section. A registered futures association shall submit to the Commission any change in or addition to its rules and may make such rules effective ten days after receipt of such submission by the Commission unless, within the ten-day period, the registered futures association requests review and approval thereof by the Commission or the Commission notifies such registered futures association in writing of its determination to review such rules for approval. The Commission shall approve such rules if such rules are determined by the Commission to be consistent with the requirements of this section and not otherwise in violation of this chapter or the regulations issued pursuant to this chapter, and the Commission shall disapprove, after appropriate notice and opportunity for hearing, any such rule which the Commission determines at any time to be inconsistent with the requirements of this

section or in violation of this chapter or the regulations issued pursuant to this chapter. If the Commission does not approve or institute disapproval proceedings with respect to any rule within one hundred and eighty days after receipt or within such longer period of time as the registered futures association may agree to, or if the Commission does not conclude a disapproval proceeding with respect to any rule within one year after receipt or within such longer period as the registered futures association may agree to, such rule may be made effective by the registered futures association until such time as the Commission disapproves such rule in accordance with this subsection.

(k) Abrogation of association rules; requests to associations by Commission to alter or supplement rules

(1) The Commission is authorized by order to abrogate any rule of a registered futures association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or effectuate the purposes of this section.

(2) The Commission may in writing request any registered futures association to adopt any specified alteration or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested,

or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or to effectuate the purposes of this section, with respect to--

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof;

(B) the method for adoption of any change in or addition to the rules of the association;

(C) the method of choosing officers and directors.

(l) Suspension and revocation of registration; expulsion of members; removal of association officers or directors

The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest or to carry out the purposes of this section–

(1) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to revoke the registration of a registered futures association, if the Commission

finds that such association has violated any provisions of this chapter or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this chapter;

(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered futures association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person–

> (A) has violated any provision of this chapter or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this chapter or any rule or regulation thereunder; or
>
> (B) has willfully violated any provision of this chapter, or of any rule, regulation, or other thereunder, or has effected any transaction for any other person who, he had reason to believe, was wilfully violating with respect to such transaction any provision of this chapter or rule, regulation, or order; and

(3) after appropriate notice and opportunity for hearing, by order to remove from office any officer or

director of a registered futures association who, the Commission finds, has willfully failed to enforce the rules of the association, or has willfully abused his authority.

(m) Rules requiring membership in associations

Notwithstanding any other provision of law, the Commission may approve rules of futures associations that, directly or indirectly, require persons eligible for membership in such associations to become members of at least one such association, upon a determination by the Commission that such rules are necessary or appropriate to achieve the purposes and objectives of this chapter.

(n) Reports to Congress

The Commission shall include in its annual reports to Congress information concerning any futures associations registered pursuant to this section and the effectiveness of such associations in regulating the practices of the members.

(o) Delegation to futures associations of registrative functions; discretionary review by Commission; judicial appeal

(1) The Commission may require any futures association registered pursuant to this section to perform any portion of the registration functions under this chapter with respect to each member of the association other than a contract market and with respect to each associated person of such member, in accordance with rules, notwithstanding any other provision of law, adopted by such futures association

and submitted to the Commission pursuant to subsection (j) of this section and subject to the provisions of this chapter applicable to registrations granted by the Commission.

(2) In performing any Commission registration function authorized by the Commission under section 12a(10) of this title, this section, or any other applicable provisions of this chapter, a futures association may issue orders (A) to refuse to register any person, (B) to register conditionally any person, (C) to suspend the registration of any person, (D) to place restrictions on the registration of any person, or (E) to revoke the registration of any person. If such an order is the final decision of the futures association, any person against whom the order has been issued may petition the Commission to review the decision. The Commission may on its own initiative or upon petition decline review or grant review and affirm, set aside, or modify such an order of the futures association; and the findings of the futures association as to the facts, if supported by the weight of the evidence, shall be conclusive. Unless the Commission grants review under this section of an order concerning registration issued by a futures association, the order of the futures association shall be considered to be an order issued by the Commission.

(3) Nothing in this section shall affect the Commission's authority to review the granting of a registration application by a registered futures association that is performing any Commission registration function authorized by the Commission under section 12a(10) of this title, this section, or any other applicable provision of this chapter.

(4) If a person against whom a futures association has issued a registration order under this subsection petitions the Commission to review that order and the Commission declines to take review, such person may file a petition for review with a United States court of appeals, in accordance with section 9 of this title.

(p) Establishment of rules for futures associations; approval by Commission

Notwithstanding any other provision of this section each futures association registered under this section on January 11, 1983, shall adopt and submit for Commission approval not later than ninety days after such date, and each futures association that applies for registration after such date shall adopt and include with its application for registration, rules of the association that require the association to--

(1) establish, training standards and proficiency testing for persons involved in the solicitation of transactions subject to the provisions of this chapter, supervisors of such persons, and all persons for which it has registration responsibilities, and a program to audit and enforce compliance with such standards;

(2) establish minimum capital, segregation, and other financial requirements applicable to its members for which such requirements are imposed by the Commission and implement a program to audit and enforce compliance with such requirements, except that such requirements may be less stringent than those imposed on such firms by this chapter or by Commission regulation;

(3) establish minimum standards governing the sales practices of its members and persons associated therewith for transactions subject to the provisions of this chapter; and

(4) establish special supervisory guidelines to protect the public interest relating to the solicitation by telephone of new futures or options accounts and make such guidelines applicable to those members determined to require such guidelines in accordance with standards established by the Commission consistent with this chapter. Such guidelines may include a requirement that, with respect to a customer with no previous futures or commodity options trading experience, the member may not enter an order for the account of such customer for a period of three days following opening of the account and receipt of a signed acknowledgment by the customer of receipt of a risk disclosure statement.

(q) Major disciplinary rule violations

(1) The Commission shall issue regulations requiring each registered futures association to establish and make available to the public a schedule of major violations of any rule within the disciplinary jurisdiction of such registered futures association.

(2) The regulations issued by the Commission pursuant to this subsection shall prohibit, for a period of time to be determined by the Commission, any member of a registered futures association who is found to have committed any major violation from service on the governing board of any

registered futures association or contract market, or on any disciplinary committee thereof.

(q) Program for implementation of rules

Each futures association registered under this section shall develop a comprehensive program that fully implements the rules approved by the Commission under this section as soon as practicable but not later than September 30, 1985, in the case of any futures association registered on January 11, 1983, and not later than two and one-half years after the date of registration in the case of any other futures association registered under this section.

1978 - Subsec. (b)(3)(B). Pub.L. 95-405, Sec. 22(1), struck out "(7 U.S.C. § 9)" after "section 9 of this title".

Subsec. (b)(10). Pub.L. 95-405, Sec. 22(2), substituted "$15,000" for "$5,000".

Subsec. (l) (1), (2)(A). Pub.L. 95-405, Sec. 22(3), substituted "chapter" for "section" wherever appearing.

Subsecs. (m), (n). Pub.L. 95-405, Sec. 22(4), added subsec. (m) and redesignated former subsec. (m) as (n).

EFFECTIVE DATE OF 1983 AMENDMENT

Amendment by Pub.L. 97-444 effective Jan. 11, 1983, see section 239 of Pub.L. 97-444, set out as a note under section 2 of this title.

EFFECTIVE DATE OF 1978 AMENDMENT

Amendment by Pub.L. 95-405 effective Oct. 1, 1978, see section 28 of Pub.L. 95-405, set out as a note under section 2 of this title.

EFFECTIVE DATE

For effective date of section, see section 418 of Pub.L. 93-463, set out as an Effective Date of 1974 Amendment note under section 2 of this title.

APPENDIX K

7 U.S.C. 25(b) (2), (3), (4) and (5)

(b) Liabilities of organizations and individuals; bad faith requirement; exclusive remedy

(2) A registered futures association that fails to enforce any bylaw or rule that is required under section 21 of this title or in enforcing any such bylaw or rule violates this chapter or any Commission rule, regulation, or order shall be liable for actual damages sustained by a person that engaged in any transaction specified in subsection (a) of this section to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce or enforcement of such bylaw or rule.

(3) Any individual who, in the capacity as an officer, director, governor, committee member, or employee of a contract market, clearing organization, licensed board of trade, or a registered futures association willfully aids, abets, counsels, induces, or procures any failure by any such entity to enforce (or any violation of the chapter in enforcing) any bylaw, rule, regulation, or resolution referred to in paragraph (1) or (2) of this subsection, shall be liable for actual damages sustained by a person who engaged in any transaction specified in subsection (a) of this section on, or subject to the rules of such contract market, licensed board of trade or, in the case of an officer, director, governor, committee member, or employee of a registered futures association, any transaction specified in subsection (a) of this section, in either case to the extent of such person's actual losses that resulted

from such transaction and were caused by such failure or violation.

(4) A person seeking to enforce liability under this section must establish that the contract market, licensed board of trade, clearing organization, registered futures association, officer, director, governor, committee member, or employee acted in bad faith in failing to take action or in taking such action as was taken, and that such failure or action caused the loss.

(5) The rights of action authorized by this subsection shall be the exclusive remedy under this chapter available to any person who sustains a loss as a result of (A) the alleged failure by a contract market, licensed board of trade, clearing organization, or registered futures association or by any officer, director, governor, committee member, or employee to enforce any bylaw, rule, regulation or resolution referred to in paragraph (1) or (2) of this subsection, or (B) the taking of action in enforcing any bylaw, rule, regulation, or resolution referred to in this subsection that is alleged to have violated this chapter, or any Commission rule, regulation, or order.

APPENDIX L

FUTURES TRADING ACT OF 1982

P.L. 97-444, see page 96 Stat. 2294

HOUSE REPORT NO. 97-565, Part 1
[Page 1]

Page 3871

The Committee on Agriculture, to whom was referred the bill (H.R. 5447), to extend the Commodity Exchange Act, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

FUTURES TRADING ACT
P.L. 97-444
[pages 56-57]

Page 3905-3906

* * *

. . . ment is made. This new procedure is designed to insure the integrity of the reparations program and of the commission's orders and to make the system more equitable for all participants.

In 1978, the Commission obtained changes in the Act which were designed to enlarge the class of persons subject to

the Commission's reparations procedures to include unregistered persons. Over the course of the past four years, the Commission has encountered several obstacles, not anticipated at the time its legislative changes were recommended, to asserting reparations procedures to include unregistered persons. Over the course of the past four years, the Commission has encountered several obstacles, not anticipated at the time its legislative changes were recommended, to asserting reparations jurisdiction over so-called "outlaw" firms or individuals. Unregistered firms and individuals often file in bankruptcy, are destitute, or have disappeared by the time a claim is asserted, resulting in uncollectible reparations awards. In these circumstances, the reparations process actually operates as a disservice to those who have already been harmed, by apparently promising recovery, which as a practical matter cannot be had. Moreover, these types of claims have served to delay the entire reparations process, thereby deferring the completion of cases where recovery is possible.

Thus, a final statutory change made by the committee at the Commission's request was to eliminate reparations claims against individuals or firms not registered with the Commission.

(c) Arbitration

The Committee's proposed amendments to sections 5a(11) and 17(b)(10) of the Act would enhance the attractiveness of arbitration as an alternative to reparations. In particular, the Committee eliminated the $15,000 limitation upon disputes which must be heard by exchanges and registered futures associations, in the expectation that

customers with more sizable claims would be encouraged to arbitrate their claims instead of petitioning for reparations hearings. As sections 5a(11) and 17(b)(10) currently read, exchanges and registered futures associations may refuse to arbitrate a customer's claim against one of their members or employees if the amount in question exceeds $15,000. The Committee is of the view that arbitration is an equally viable forum for resolving customer claims in excess of $15,000 and there is no logical reason why reparations should be the only out-of-court forum for resolution of these disputes.

The Committee proposed amendment to sections 5a(11) and 17(b)(10) would also delete the present language in the Act requiring that the arbitration procedures not result in any compulsory payment except as agreed upon by the parties. This change is intended to make clear that awards rendered on counter-claims in arbitration are binding without the necessity of any agreement. H.R. 5447 does not affect the existing requirement that the use of arbitration by the customer is voluntary or the Commission's understanding that exchange members must participate in arbitration proceedings which the customer has elected to pursue.

(d) Private Rights of Action

At the time the Committee considered the bill, the Supreme Court had not yet resolved the issue of whether a private right of action could be implied under the Act. The Committee is of the view that the right of an aggrieved person to sue a violator of the Act is critical to protecting the public and fundamental to maintaining the credibility of the futures market.

To that end the Committee added a new section to the bill to provide specific authority for private rights of action for recovery of actual damages against violators of the Act. In order to recover the violation must have arisen from a transaction on the futures market, a regulated option or leverage contract, or participation in a commodity pool.

The Committee also specifically provided for liability for actual damages by a contract market, clearing organization of a contract market, licensed board of trade or registered futures association market, that failed to enforce a bylaw, rule or regulation made a condition of its designation or license. In addition, a cause of action could be brought against an officer, director, or employee who willfully aided or induced such a violation. The cause of action in these cases would be restricted to cases where the plaintiff had engaged in a regulated commodity transaction and could show that there was bad faith in failing to take the necessary action. Any action by a private litigant under the Act must be brought with two years after the date the cause of action accrued.

The Committee included these restriction on the causes of action to avoid suits for speculative damages to assets that are affected by fluctuations in prices on the commodity market but which are not the subject of transactions on such market.

The availability of these remedies-reparations, arbitration and private rights of action-supplements, but does not substitute, for the regulatory and enforcement program of the CFTC and self-regulatory agencies. The Committee fully expects that these agencies will vigorously use the tools at its command to protect the investing public so that it does not

become necessary to rely on private litigants as a policeman of the Commodity Exchange Act.

IX. COMMISSION EMERGENCY POWERS

The Committee included in its amendments to the Commodity Exchange Act new provisions to assure that the Commission would have the tools it needs to act promptly in emergency situations to protect the public interest and at the same time establish a mechanism that will assure that the Commission does not act in an arbitrary or capricious manner.

Under current law in emergency situations the Commission is authorized to "take such action as in the Commission's judgment si necessary to maintain or restore orderly trading in or liquidation of any futures contract." The Act defines the term "emergency" to mean in addition to threatened or actual market manipulation and corners, any action of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.

As described elsewhere in this report, there was concern as a aftermath of the silver affair as to the breadth of the Commission's powers in emergency situations. Accordingly, the Committee has amended the Act to make explicit that this power of the commission extends to the setting of temporary emergency margin levels

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